

This Week's Top Articles

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Joe Magyer on pricing power, customer loyalty and the network effect

Graham Hand

Introduction: Joe Magyer is Chief Investment Officer of Lakehouse Capital, and Portfolio Manager of two unlisted funds, the Lakehouse Small Companies Fund and the Lakehouse Global Growth Fund. Much of this discussion relates to the Small Companies Fund which invests in small, fast-growing companies in Australia and New Zealand.

GH: One of the main characteristics you look for in a company is pricing power. How do you identify it and convince yourself that it's enduring rather than short term?

JM: On the analytical side, we want businesses with high and stable gross margins, and if they don't have that, then odds are they don't have pricing power. The tricky part is going beyond that. Businesses that have exceptional pricing power usually don't come out and say it bluntly. They don't want regulators and competitors to know and they don't want to upset customers. So you have to piece it together. We also look at results relative to volumes and what competitors are doing.

It's not hard to raise prices during an economic expansion. But we saw some businesses in the US that prided themselves on CPI plus price increases for six or seven years and then they gave it all back during the last recession. Anytime you see that, that's a big turnoff.

GH: And you focus on brand loyalty. How do you test or verify that?

JM: That's one of my big, personal fascinations. Most investors chronically underestimate the value of extremely loyal customers. It's partly because they're so rare, and partly because in Australia, so many investors cut their teeth on mining and retail banking, neither of which are known for extreme loyalty.

GH: Banks tend to take advantage of existing customers and chase the new ones.

JM: Yes. John Mackey, who's the founder of Whole Foods and on our parent company Board of Directors, told me if you treat your customers like an annuity, you open yourself up to disruption. It doesn't mean that they're going to run away but you put a target on your back. So that's why we focus on loyalty rather than just switching costs.

Let's say you've got two businesses, one with 90% retention and another with 80%. Optically, that's not a big difference. In practice, the one with 90% retention has an average customer life of a decade, and the other is five years. So the business at 90% can spend twice as much to acquire customers, which is a huge strategic advantage. Or they can pay the same amount and get double the margin per customer. Either way, it's a far superior business and much more stable.

GH: And what's the difference between loyalty and switching costs?

JM: Switching costs make it a headache for businesses to move on, and while that's valuable in terms of keeping customers, we much prefer to see loyalty based on products and services that delight the user. Instead of just seeing, say, 90% retention, which is still great, we find revenue retention that's above 100%. Customers are so delighted that they expand their spend. For example, more than half the customers that use Atlassian are like that, it's a product that people love that's hyper scalable.

GH: What's the best example of pricing power, retention and loyalty you have seen in an ASX-listed company? One that even surprised you, maybe after you've invested?

JM: Altium (ASX:ALU) has been a phenomenal success story that not a lot of people pay attention to. And I think it's because their core product is not very accessible to everyday people. It's software for designing printed circuit boards, not something any of us are likely to be using. But over the past several years, they consistently raised prices with rising retention rates. That's a rare phenomenon. It shows the quality of the work and product enhancements they've made. They shorten the product release cycle, iterate faster, now they do upgrades faster, and customers reward them with a willingness to pay more for the products. You don't see that every day.

GH: That's a great example but it wouldn't strike me you would have the expertise in that technology, yet you invested at an early stage. How do you gain the confidence to invest in a company that makes printed circuit boards?

JM: A lot of fund managers pride themselves on qualitative research, but more valuable is working off the full data set of a company-wide story. With Altium, we looked at competitor results to see what they were doing, and it was clear that Altium was gaining share the market while raising prices. I would never try to master the art of designing circuit boards.

GH: Isn't the major difficulty investing in an Afterpay or Altium that there's so much dependence on future growth, with P/Es of 50 or 80, or not even a making a profit. How do you convince yourself not so much about the current business, but the incredible growth trajectory?

JM: We get fired up about situations with self-reinforcing dynamics. The network effect is one of those. My affinity for networks is that it's hard to find any other business model where so much value can be created so quickly. The market is often shocked and surprised at how quickly it can all come together, and Afterpay is an example of that. By the time a lot of fund managers even understood the thesis, there was already a lot of value creation and millions of customers. We love companies with lots of optionality and Afterpay has that.

GH: Do you get most confidence from the business idea or is it about the people?

JM: It's a mix of both. When I came out of undergrad at 22, I thought investing decisions was about spreadsheets, but then you get out in the real world. In small caps, we are very focused on management. Small caps often don't have much of a balance sheet, they invest 100% or more of what they earn. So you are betting heavily on the capital allocation and the leadership skills of the team. We have visited the small companies we own an average of nine times. It's less of a factor for some of the bigger businesses we own. The more money you reinvest, the more important it is that the management gets all those things right.

We own Visa, and no offense to the team there, but I'm pretty sure it could be run by a ham sandwich for a year and most people wouldn't notice. There's a charm in that.

GH: You've had an excellent run recently, topping the Morningstar tables, but in the last five years, 'growth' has beaten 'value' across all sectors. Is the performance more than the right place at the right time?

JM: We ask ourselves this all the time. Every good investment outcome has an element of luck, for better and worse. We've had the wind at our back in terms of growth, and some of the industries we focus on have done well, particularly enterprise software. That said, we've selected well in those sectors, so it's not just sector tilts. We've focussed on enterprise software and recurring revenue business models but there's some degree of fortunate medium-term timing.

GH: In a recent article in Cuffelinks, you wrote about 'fascinations'. Tell me more about them.

JM: Most funds are built around trying to cover the waterfront. There's a guy covering North America, this woman's in media, it's sector based. We think there are big problems with this approach. You get pitched ideas from all your analysts, regardless of whether it's actually a good place to be investing because that's what you've told them you want.

Not all industries are created equally. Some historically have low returns on invested capital or volatile returns on capital. And some of them are at the higher end. I don't see a lot of appeal in focusing our time or capital on industries that might be melting ice cubes or price takers. Fortunately, here in Australia, many people focus on industries where that is the case, such as Materials, so we have less competition in other parts of the market.

Our ultimate objective is to construct a portfolio of businesses that we consider have superior long-term prospects and reinvestment potential. We spend a lot of time talking about the subjects that we're fascinated about.

GH: Have you got a couple of favourite stock stories?

JM: Sure. Audinate (ASX:AD8) is one of our favourites that not a lot of people are familiar with, and it's only covered by three analysts. The business has more than reached a critical mass. Its core product is a software protocol called Dante that allows different pieces of digital audio to talk to one another. And it ran away from the competition because its product has the lowest latency. You could have a big auditorium, and your microphone will connect to the speakers in a clear way. There were people in the space before them, but because their product is functionally superior, manufacturers rallied around them. There is now a clear market winner and speaker manufacturers who were on the sidelines now see a leader so Audinate is gaining share of that market. Over 90% of their competition is just cables but digital is a better option.

GH: Is this, say, in a concert or conference set up, instead of cables running along the ground, the equipment is linked digitally?

JM: Exactly. It's a big improvement and a high margin business, and they are pushing into AV, such as in a sports bar with lots of screens, solving the same cabling problem.

GH: And a second stock?

JM: We've already talked about Afterpay. A lot of people understand the Australian opportunity but we think the US market, new products and extending the brand give a wide range of options.

Facebook is the biggest position in the Global Fund. The business could not have looked worse in headlines over the past couple of years, and they've made a lot of mistakes which they were rightfully fined for. But a lot of people look at the headlines and assume that the business is doing poorly or even shrinking. The opposite is the case. More than two billion people use the core Facebook business monthly and it's growing in every region. Revenue was up 30% in constant currency terms year on year. Then you've got Instagram, Whatsapp and Messenger, each of which has more than a billion monthly active users.

Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. [Lakehouse Capital](#) is a sponsor of Cuffelinks. For more articles and papers by Lakehouse Capital, please [click here](#).

The Lakehouse Small Companies Fund owns shares of Altium, Afterpay Touch, and Audinate. Both Joe and the Lakehouse Global Growth Fund own shares of Visa and Facebook.

A fair go in favour of Labor's franking policy

Leisa Bell

Introduction

Labor's campaign slogan is 'A fair go for Australia', so let's have a fair go on franking. Some readers are disappointed that Cuffelinks has published many articles that are critical of Labor's franking credits proposal, but we have not received one article making an expert case for Labor's policy.

Note also that many articles have suggested alternative strategies if the policy is legislated, but the articles have not been criticising the policy.

Cuffelinks encourages comments from all perspectives, provided they are (fairly) respectful and constructive. What follows is an edited collection of comments made on our website in favour of Labor's policy, and the article to which the comment relates.

Selection of edited comments can be accessed on our website [here](#).

The role of bonds and hybrids in franking loss

Justin McCarthy

Most of the discussion on Labor's proposed changes to franking credits has focused on how retirees and investors in SMSF pension phase might experience a significant fall in their (after-tax return) income.

Little has been written about the impact on bonds and hybrids and the solution they may provide. It is also a timely reminder to assess regularly the asset allocation and balance of investment portfolios. The current environment provides a unique opportunity to potentially decrease risk and increase overall return with a reallocation between cash, bonds and equities.

Currently, individuals and superannuation funds are entitled to a refund of franking credits if the franking credits plus any PAYG tax paid by the individual or fund exceeds their tax liability. Under Labor's proposal, with some exceptions such as the 'pensioner guarantee', refunds that exceed tax liabilities will no longer be available for most taxpayers.

Potential loss of income

The practical implication is that retirees and in particular SMSFs in pension phase are most at risk of losing significant franking credit cash refunds. This can reduce after-tax dividend income by up to 30%.

For example, an SMSF in pension phase (hence 0% tax rate) with a share portfolio of \$1.5 million earning a dividend yield of 6.0% **plus** franking would currently be entitled to a refund of \$38,571.43. Under the Labor proposal, this entire refund could be lost for some investors.

$\$1.5 \text{ million} \times 6.0\% / (1 - 30\% \text{ tax rate})$
= \$1.5 million x 8.57% fully franked dividend
= \$128,571.42 of which \$90,000 is received in cash and \$38,571.43 in franking credits.

How hybrids are different

The same SMSF with \$1.5 million in franked hybrids paying 6.0% (inclusive of franking), as opposed to dividend paying shares, would have lower overall income and franking refund component.

This is because the market quotes share dividends as a yield **before franking** whereas hybrids are quoted **inclusive of franking**. A 6% dividend on say a bank share is actually 8.57% (or 42.9% higher) when franking is added. A 6% fully franked hybrid pays \$63,000 in cash income and \$27,000 in franking credits. The latter is at risk of being lost to some investors.

$\$1.5 \text{ million} \times 6.0\% \text{ (inclusive of 30\% franking credits)}$
= \$90,000 fully franked distribution, of which \$63,000 in cash i.e. $6\% \times (1 - 30\% \text{ tax rate})$ and the balance of \$27,000 i.e. $6\% \times 30\% \text{ tax rate}$ in franking credits.

The role of bonds and hybrids in limiting the impact

Individual circumstances vary, including the entities and tax structures available, and other articles in Cuffelinks have described alternatives to reduce the impact of a loss of franking. See, for example, [Steps SMSFs may take to beat Labor's franking](#), [On franking, all public funds are not the same](#), [Labor franking policy will change behaviour](#), and [How SMSFs can utilise franking credits under Labor](#).

There are also a number of strategies specific to bonds and hybrids which have received little commentary. In particular, bonds and hybrids can provide effective solutions for those who need to maintain high income levels. Options include investing in:

A high-income bond portfolio. Bonds do not have any franking credits and a relatively conservative bond portfolio can be tailored with returns of 6-7% p.a. For investors comfortable with sub-investment grade bonds, the ability to construct a high-yielding portfolio of 7%-plus is possible as there are a number of bonds with returns in the high single digits including 6-12-month senior secured property bonds with low Loan to Valuation Ratios around 50%. A number of foreign currency bonds also come with high running yields such as the Citigroup USD 3mth Libor+6.37% and the NCIG 12.5% USD bond (but these also carry currency risk).

Indexed annuity bonds which pay down principal and interest over their life. These are typically issued by very high-quality A, AA and AAA rated government or public private partnership (PPP) entities and are also indexed to inflation, providing excellent protection. The downside is that at the end of the term the capital value has been completely exhausted but they are a good vehicle for those looking to enhance the cash return received each quarter

Hybrids that pay no or minimal franking credits. Two of our favoured AUD investments across the bond and hybrid market are the ASX listed National Income Securities (ASX:NABHA) and Macquarie Income Securities (ASX:MBLHB). These legacy Tier 1 hybrids were issued in 1999 and neither has any franking attached to their distributions. We expect both of these securities to be redeemed for \$100 before 2022. While the running yields are 3.6% and 3.8% respectively, with the current prices in the high \$80s, yields to call of over 10% are expected, adding to the consistent 10-15% annual return each has provided since early 2016. Repeating, none of the return includes a franking component. A number of 'new style' Basel III-compliant hybrids are also available with minimal or partial franking credits including those issued by AMP and Macquarie Bank.

Over the years we have often written that we do not subscribe to the view that 'all hybrids are bad'. Rather we suggest investors consider the specific risk and return parameters of each security (including the impact of franking credits). At present, we still see value in legacy hybrids with no franking credits but generally believe new style hybrids are a touch expensive given the risk of a possible sell-off following a Labor election win. However, should credit margins on new style hybrids approach +5% again, we would most likely see value outweighing those risks.

An opportunity to review portfolios

The Labor franking policy provides an opportunity for investors to consider not only their tax position but also their overall investment portfolio balance. As a general rule, most Australians (and in particular SMSFs) are over-exposed to property, equities and cash. On the flip side, we have one of the lowest exposures to bonds of all OECD countries. Direct investment in bonds (as opposed to via a managed fund) is less than 1% across the SMSF sector.

With cash rates at 1.5% and market predictions of further RBA cuts, term deposit rates are likely to have a '1' handle for some time. After factoring in inflation, many cash positions generate a negative real return. Large cash positions represent a drag on portfolios that can be replaced with a variety of bonds yielding 3.5-6.0%. If Labor's franking policy is enacted, investors could reduce risk and volatility and maintain or even increase (after-tax return) income by re-assessing their allocation to bonds and select hybrids.

Justin McCarthy is Head of Research at [BGC Fixed Income Solutions Australia](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual. Investors should consider their risk appetite and product knowledge and seek financial advice before taking action.

For other articles by BGC Fixed Income Solutions, see [here](#).

It's unlikely Uber has a long-term future

Roger Montgomery

When Uber's private equity owners and other shareholders hinted they were ready to float in late 2018, a valuation of up to US\$120 billion was quickly adopted following investment banker indications. But then rival ride-hail and loss-making, Lyft, hit the market and promptly fell 28%, from a first day market valuation of US\$22 billion to just US\$16 billion at its 15 April low.

Uber Technologies Inc has now unveiled its IPO terms and Lyft's on-market experience has had a detrimental impact on the valuation. Uber is seeking a valuation of between US\$80 billion and US\$90 billion (still above the last private share sale at US\$72 billion) and is looking to raise as much as US\$9 billion. This is still an extraordinary amount considering the company has stated that it doesn't make any money and that it may not make any money.

Cheap money looking for new homes

Since the GFC, cheap and abundant money searching for a better yield filled the coffers of funds launched by private equity managers, which in turn allowed them to gamble on some unconventional roads to prosperity.

In the case of Uber, one can reasonably assume the loss of US\$7.9 billion since 2009 is due to an attempt to leverage a first-mover advantage and synthesise a network effect to become more valuable as more customers adopted it. The only problem of course is that more Uber users doesn't make the service better.

And Uber doesn't benefit from scale advantages either. Consider that taxi companies rarely, if ever, monopolise more than one city and that there has been little desire on the part of buyers to consolidate taxi operators.

Of course, Uber's strategy necessitated the disruption of incumbent taxi businesses, which initially regulators were delighted about. Competition begets lower prices and the cushy taxi monopolies and duopolies of many cities needed a kick in the backside. But the strategy also relied on by-passing the proper employment of drivers, something society and their representatives might ultimately be less happy about.

By throwing enough money and lawyers at the challenge, however, it was probably hoped that Uber would emerge victorious before any regulator could catch up.

Ultimately, great for consumers, lousy for investors

Perhaps what private equity didn't count on was the emergence of competitors and the rapid adoption of their offerings. The preponderance of competitors such as Lyft in the US, Didi in China, EasyTaxi in Latin America, Grab in Asia, Yandex in Russia (now merged with Uber), Careem in the Middle East, Taxify (backed by Didi and now rebranded Bolt) and Gett in the UK, Israel and Russia, is evidence of not only lower than anticipated barriers to entry but also the commoditisation of the offering.

This suggests that depicting Uber as a technology company that transforms initial losses into future profits is an error of judgement. Uber, and ride hailing more generally, I believe will prove to be merely another example in a long line of 'technologies' that proved to be great for consumers but lousy for investors.

I cannot think of a large and successful major technology company that was as unprofitable for as long as Uber has been. Uber is already ranked as the biggest loss-making start up in history. By way of comparison both Facebook and Amazon were generating positive cash flows by year five.

The boldness of a strategy to offer an under-priced product (the providers don't generate an economic return), flood the streets with cars and lose billions in order to decimate incumbents and bully regulators is typical only of boom-time conditions.

Private equity simply used mountains of other people's money to engineer an outcome that history suggests must be organically-derived to prosper. Uber has raised more than US\$20 billion since its Series-A funding round. This is two-and-a-half-thousand times more than Amazon's pre-IPO funding and suggests Uber is being pushed to consumers rather than being pulled by them. It's an artifice than cannot be maintained indefinitely.

In his book *The Origin and Evolution of New Businesses*, professor Amar Bhide, stated;

"Many giga-businesses have no clue, when they start, about how they will become behemoths — think Microsoft developing Basic for the Altair in 1975, Sam Walton starting a country store, and Hewlett and Packard selling audio-oscillators. But being small, they can experiment to figure out what is profitably scalable and make radical changes if necessary. Which is why not having deep pockets to start with is a blessing not a curse."

It is clear that Uber is providing its services at a discount to its costs. In 2018 that discount was roughly 27%. Meanwhile Uber drivers are reported to now be earning less per hour than taxi-driving operators. Clearly Uber cannot cut costs to boost returns without triggering even higher driver churn.

The popularity of the service is therefore more than partly due to it being too cheap.

IPO will pass the parcel to 'greater fools'

Tech insiders typically make all their money prior to the company floating. Venture capital and private equity funds and their limited partners are patient investors, happy to wait to sell their shares to a 'greater fool'. But the stock market is far less generous. In the quarter to 31 December 2018, Uber's bookings and revenue growth slowed dramatically. Year-on-year bookings growth has slowed from nearly 75% to less than 25%.

And this number may also reflect the disturbing fact that the proportion of people hailing a ride more than once per week is falling.

I am reasonably confident that investors who buy shares in Uber's IPO will not make returns that justify the risk because I am far less confident that Uber has a place in the future of transport.

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

Recession and why timing markets doesn't pay

Matthew Tufano

When do we know for certain that we are on a path toward recession and that what we are experiencing is not simply a reversion to trend? How can investors prepare? Those questions captured the minds and emotions of investors and pundits alike through the first quarter of 2019.

While some of the global economic data released in Q1 was disappointing, we are not put off. The theme of Vanguard's 2019 outlook was 'down, but not out' as we anticipated some deterioration in economic growth indicators. Holding that view is easier said than done when consumption, income, housing, and manufacturing indicators in several nations signal weakness. Almost in spite of the uncertainty, however, share markets in Australia and overseas returned over 10% for the first quarter.

The yield curve and central banks

It was hard – even for the most steadfast of investors – to ignore the debate around the economic cycle once the US Treasury yield curve briefly inverted in the final weeks of March 2019. When short-term interest rates are higher than long term rates, investors become pessimistic about what could happen in the next year, yet optimistic when looking five to ten years into the future. Traditionally, this pattern has preceded every major US recession in recent memory, so quite understandably, investors are taking these warning signs seriously.

Central banks only added to the feeling that economic storm clouds are gathering. Ironically, their actions might have been intended to instill confidence in their respective economies, but markets, especially bond markets, had none of it. The US Federal Reserve revised its vaunted 'dot plot' to suggest that interest rates would be on hold for the rest of the year; they had previously signalled two more hikes. Locally, the Reserve Bank of Australia became more tentative in its official policy communications. Even the Reserve Bank of New Zealand changed its tune and openly discussed the possibility of a rate cut.

Investors are now asking; "What do the banks know that we don't?"

Economic and market outlook

This questioning comes at a precarious time for the global economy, as we recently passed the 10-year mark from the onset of the Global Financial Crisis. Those who say the US economic expansion must end soon, simply because the expansion has been remarkably long, overlook Australia's record-setting recession-free expansion in their review of the global economy. Investors feel that we are close to crossing a line, albeit a blurry one, between economic growth reverting to trend (2% in the US, 2–3% in Australia) and an outright global slowdown.

Part of this concern is driven from a tightening of financial conditions. According to our analysis, financial conditions and heightened anxiety over economic policy probably contributed to some of the decline in US GDP growth for the last quarter of 2018. In a recent research note, *Known unknowns: Uncertainty, volatility, and the odds of recession*, we estimated that these shocks could have subtracted as much as 0.4% from 2019 GDP growth.

Key conditions under the microscope: Financial Conditions and economic policy uncertainty

Figure A: US Financial Conditions tightened significantly towards the end of 2018

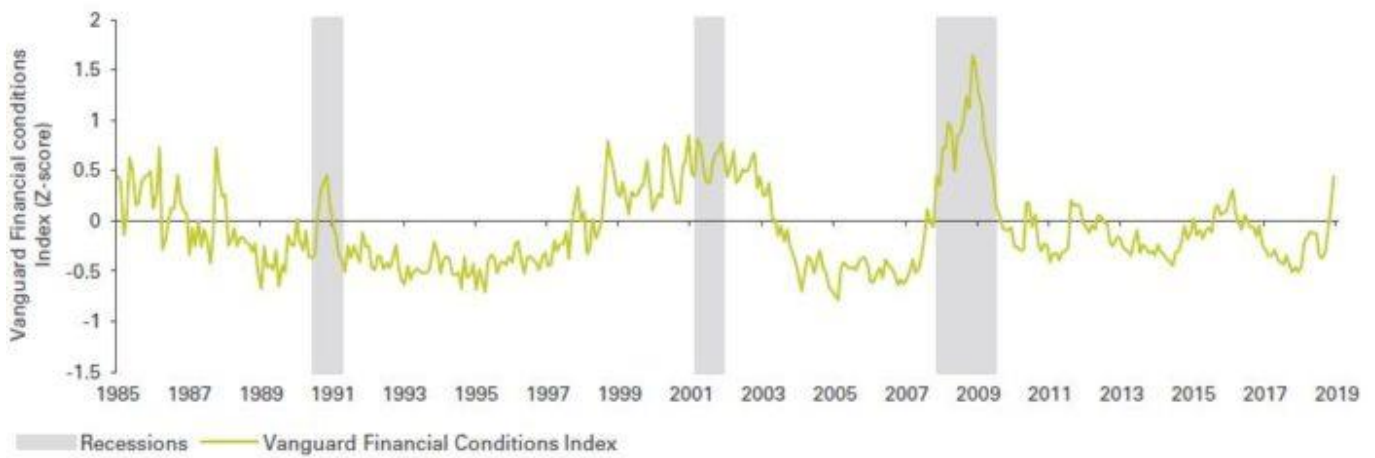
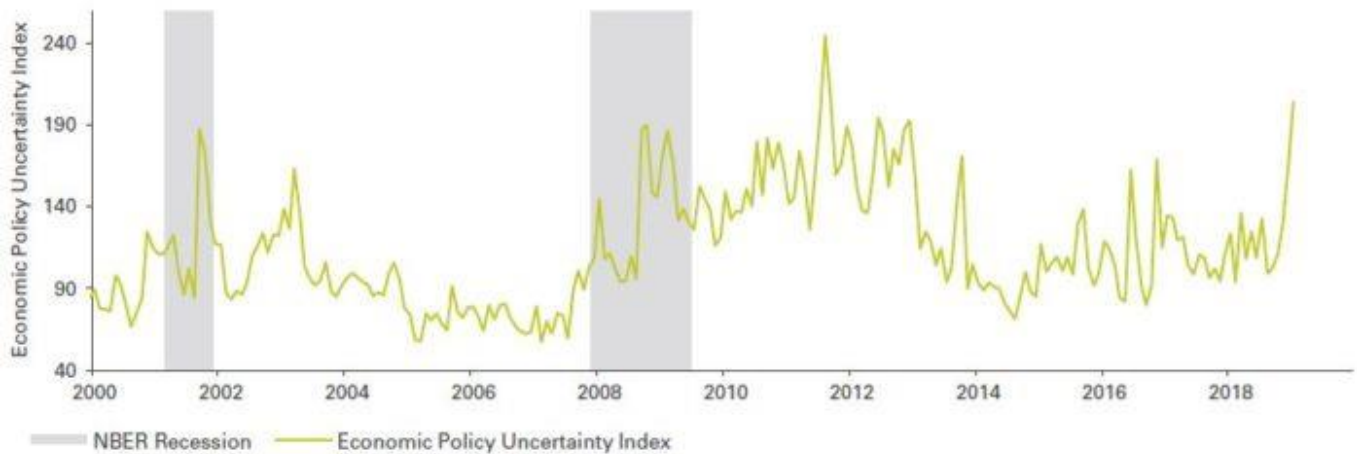


Figure B: An uncertain and volatile end to 2018



Notes: The Vanguard Financial Conditions Index is a dynamically-weighted index of 12 financial variables designed to capture overall financial conditions.
Sources: www.policyuncertainty.com, Thomson Reuters Datastream and St Louis Federal Reserve Database

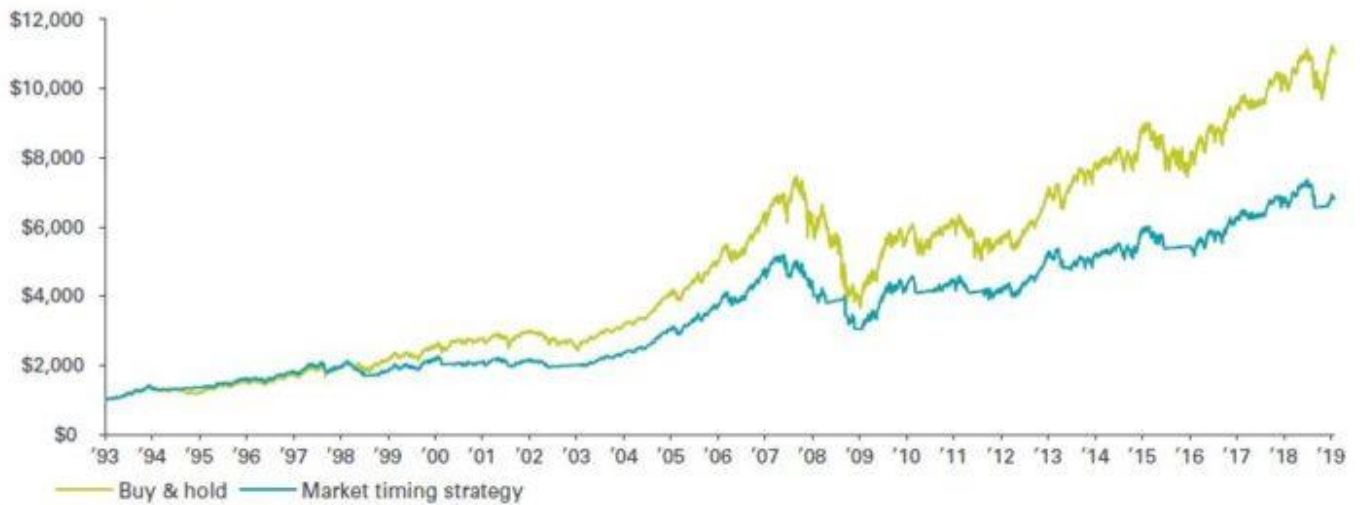
Inevitably, with each new development in this cycle, we are asked by investors what they can do to prepare. Regular readers of Vanguard’s commentary will not be surprised by our answer: revisit asset allocation, diversify, and review active risks in your portfolio.

Market timing does not pay

Attempting to time markets can backfire and lead to long term underperformance, as our analysis shows in the figure and table below. The questions investors ought to be asking are: ‘If a recession occurs, how should I respond?’, ‘Am I adequately prepared?’ and, ‘Does my financial plan reflect my comfort with uncertainty?’ rather than ‘When will the next recession occur?’

Adequate preparation, whether increased savings, a new asset allocation, or even a conversation between an adviser and their client, is the best way to prepare. The market will take us for a ride as it tries to guess (with limited success) what will happen in 2019. If we stay calm and adhere to a long-term approach, we limit the effect of the market’s fits and tantrums on our journey toward investment success.

Market timing doesn't pay: Growth of \$1,000 using a 10% sell and 10% buy strategy



Source: Vanguard calculations, using data from Factset

Even for a range of market timing strategies, in the long run buying and holding has delivered superior returns

Strategy		Annualised returns		
Selling after a % fall from the peak	Buying after a % rise from the bottom	Buy & hold	Market timing	Buy & hold outperforms by
10%	10%	9.71%	7.69%	2.02%
5%	5%	9.71%	2.57%	7.14%
5%	10%	9.71%	4.91%	4.80%
10%	5%	9.71%	7.65%	2.06%

Notes: The data shows a comparison of the performance of a buy & hold strategy and market timing strategy. The time period is 1 March 1993 to 31 March 2019. Australian equities are represented by the S&P/ASX 300 Total Return Index and cash by the Bloomberg Ausbond Bank Bill Index. Trading costs are set at 0.5% of transaction amounts. Source: Vanguard calculations, using data from Factset

Matthew Tufano is an Economist at [Vanguard Australia](#), a sponsor of Cuffelinks. This article is for general information purposes only and does not consider the circumstances of any individual.

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

When is it worth establishing a second SMSF?

Monica Rule

With the introduction of the Transfer Balance Cap, some SMSF members were required to move assets from their retirement pension account to their accumulation account to ensure their pension account did not exceed \$1.6 million on 1 July 2017.

Other superannuation changes have also meant that if an SMSF member has a total superannuation balance of \$1.6 million across all of their superannuation funds, and the member is in receipt of a retirement pension, then their SMSF can only calculate the income tax exemption using the unsegregated method.

Where is best to hold pension assets?

Some SMSF members wonder if it is worth establishing a second SMSF where they hold pension assets in their existing SMSF and accumulation account assets in the second SMSF.

There are some good reasons to have two SMSFs. One SMSF could be used to retain higher-yielding investments in the tax-free pension fund and lower-yielding investments in the tax payable accumulation fund.

It may assist the member's pension balance to grow faster than their accumulation account due to the growth of assets in the pension fund.

On the other hand, if all assets were in the one SMSF, then the investment earnings need to be allocated in proportion to the member's pension and accumulation account balances. Also, in the event a liability arose from an investment in one SMSF, the assets in the other SMSF would not be exposed or affected.

Assets in the two SMSFs can be segregated for investment reasons where different strategies are developed for members with different risk profiles. This is especially useful if the SMSF members are of different ages and at different stages of their lives. As the number of members in an SMSF is limited to four, having two or more SMSFs will also allow larger families to have their children included in the SMSF environment.

It may also assist in asset protection in the event any family member is exposed to a separation claim due to a relationship breakdown.

Some members may establish a second SMSF so that they can have different death benefit nominations in each SMSF, as well as the control of each SMSF left to different people. This may avoid situations where a death benefit is left for one person but the control of the SMSF is passed to a different person, which may result in the controlling person being tempted to ignore the wishes of the deceased member when allocating the death benefit. Members will need to ensure appropriate death benefit nominations are put in place especially with reversionary pensions.

Doing it for the right reasons

There is nothing stopping someone from establishing a second SMSF and doing so on its own would not be a concern to the Tax Office. This is especially so if there are genuine commercial or family reasons for doing so. However, the ATO would be concerned if the member of the SMSFs started manipulating assets between the two SMSFs or switching each of the SMSFs between accumulation phase and retirement phase.

The downside of having two SMSFs is of course the additional administration costs and the initial process of transferring selected assets from the existing SMSF to a newly-established SMSF. Members need to document transactions with care so that there is no confusion as to which assets belong to which SMSF.

Moving assets between the two SMSFs will result in a capital gains tax event with the appropriate tax treatment. Stamp duty may also apply. Members need to consider 'related party' rules when transferring assets between SMSFs as only listed securities and business real property can be transferred between related parties.

Anyone that is considering establishing a second SMSF should discuss their situation with a licensed financial planner who specialises in the superannuation law. It is a costly strategy and it doubles your compliance obligations so it's not something members should enter into lightly.

(Editor footnote: One reason to consider retaining a single large SMSF is that if Labor's franking credits proposal is adopted, an SMSF might have tax payable on the accumulation assets to use the franking credits generated by the whole fund, including the pension assets. If assets are separated into a pension SMSF, franking credits may be lost in future).

Monica Rule is an SMSF specialist and author. Her advice is general in nature and you should seek advice that relates to your specific circumstances before making any decisions. www.monicarule.com.au

For anyone working with SMSF clients, Monica will be speaking at a webinar hosted by the Institute of Public Accountants on [Building a Nest Egg in a Self-Managed Superannuation Fund](#), on 16 May 2019.

No logic in reinstating the complex 10% rule

Noel Whittaker

I appreciate that people of goodwill have competing views about which policies would be best for Australia in the long term, but in superannuation, Labor is pushing one particular policy that I regard as indefensible. That is the repeal of legislation allowing employees to claim a tax deduction for additional voluntary superannuation contributions.

For many years, superannuation regulations prevented a person from claiming a tax deduction for additional personal concessional contributions if an employer was contributing for them. There was no logic to it, and nobody has ever been able to tell me the reasoning behind it.

The unpopular and complex 10% rule

This silly rule was introduced to assist doctors in private practice who did a relatively small amount of work outside the practice. As the rules stood then, even a small payment from a hospital, from which superannuation had been deducted, was sufficient to deny the doctor the right to claim a tax deduction for contributions made from their main source of income.

So the government of the day created the 10% rule, which allowed people such as doctors to claim a tax deduction for their own contributions provided their external income represented no more than 10% of their gross income.

That was bad enough, but the rule also created two classes of citizens: a sole trader could make additional personal contributions and claim a tax deduction, but an employee of a company could not. There was a loophole if their employer was prepared to offer salary sacrifice, enabling their employees to contribute part of their gross pay as an additional superannuation contribution.

Even if you were one of the lucky employees with access to salary sacrifice, you could still find yourself with problems. Some unscrupulous employers took the opportunity to treat the extra salary sacrifice contributions as part of their 9.5% compulsory superannuation obligation, conning their employees by reducing their compulsory contribution.

But generally, the outcome was that employees of companies that offered salary sacrifice were better off than those working for businesses where it was not offered.

The rule was removed on 1 July 2017

Finally, thanks to the Turnbull Government, all taxpayers were given equality. From 1 July 2017 everybody has had the opportunity to make additional superannuation contributions up to the concessional limit of \$25,000 a year (including employer contributions) and claim a tax deduction, not just those who can salary sacrifice.

Many employees are cash poor and cannot afford to have their fortnightly pay reduced by additional contributions even if the employer does offer salary sacrifice. But they may well be able to save a bit here and there and make an extra contribution at the end of the financial year. One major benefit of doing so would be to get a tax refund, which could be used as a contribution to superannuation in the following year.

Now Labor, despite always arguing about inequality and claiming to be the champion of women, is threatening to reverse this long overdue and essential change to the rules. They want to bring back the 10% rule, and revert to a system in which certain privileged employees got an effective tax deduction through salary sacrifice while less fortunate ones missed out. Where is the logic in that?

Maybe there's a hint on the Labor website, which points out that only 2.3% of taxpayers made \$25,000 or more of concessional contributions in 2012–13. But that's not relevant. The new rules allowing all employees to make concessional contributions only took effect from July 2017. Before then, most employees were prohibited from making additional tax-deductible contributions – so of course there were few extra deductible contributions! It's a flawed proposal, based on flawed logic.

Proposal on franking credits unfair

Most voters have no idea how the imputation system works.

The word 'imputation' means to give credit for, and the imputation system was introduced to prevent double taxation of company dividends. Dividends from Australian shares are the only Australian income stream where profits are taxed before you receive them. The franking credits are simply a credit for tax paid by the company on behalf of the investor.

If you invested in direct property or a property syndicate, or received interest from a bank account, the income from that investment would be paid to you in full and you would pay tax on it at your normal marginal rate. Think about two investors – one receives a franked dividend of \$700 plus a franking credit of \$300 for tax deducted by the company. The other receives a \$1,000 distribution from a property syndicate and no tax is deducted by the company paying it.

If they were both retirees on zero taxable incomes, the franking credit of \$300 would compensate the first investor for tax deducted by the company paying the dividend and under present policy would be refunded to him. Therefore, both investors would receive \$1,000 net.

An analogy would be a person who is a PAYG employee and has tax taken out of their pay. When they do their tax at the end of the year, losses from activities such as negative gearing may reduce their taxable income. They will then get a refund of part of the PAYG tax deducted by the employer.

Now the unique thing about numbers is you can offer different interpretations. Shadow Treasurer Chris Bowen was recently quoted as saying:

"Think about a nurse who earns \$67,000 a year – we make her pay \$13,000 in tax. Yet a retired shareholder with a substantial balance in superannuation could receive \$67,000 in income with his fund paying zero tax. On top of that he expects the government to write the fund a cheque for \$27,000. That is not okay."

But there are many anomalies which could be described as "not okay". Why should a top marginal taxpayer receive 49% back from the government on tax losses if he negatively gears an investment property, while the nurse gets back just 34.5%. Why should some politicians be allowed to access their superannuation before they turn 60?

Our superannuation system is designed to encourage people to invest for their retirement which means people with money in super will be often be better off tax-wise than people out of it.

But our retiree has a lifeline. He could get around the franking credit changes by transferring his SMSF to a retail or industry fund where the franking credits will be used to pay contributions tax and earnings for members in accumulation phase.

One group will be left stranded

This group is the self-funded older retirees who are not in super and can't contribute because of their ages. Think about a self-funded retiree, not in super, whose income from dividends is \$67,000 a year. The taxable income would be \$95,714, after adding \$28,714 in franking credits. Tax on that \$95,714 would be \$24,825 (\$22,911 tax, plus Medicare levy of \$1,914) leaving a refund of just \$3,889. That's way different to the \$27,000 that the Shadow Treasurer is quoting. Furthermore, the retiree's effective tax rate is almost 30% while the nurse's is 19.4%. Is that fair?

Talking about fairness, Labor has been very quiet about its intention to abolish catch-up super contributions, as well as stopping employees making extra super contributions and claiming a tax deduction. If that gets up, our nurse will not be able to make extra super contributions to make up for time spent raising a family, and she won't be able to boost her super contributions unless her boss offers salary sacrifice. That is definitely not okay.

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10 quick lessons from Buffett's 2019 Meeting

Wilbur Li

Every year, the city of Omaha in the US welcomes thousands of shareholders to Berkshire Hathaway's Annual Meeting. Before the formal proceedings, Warren Buffett and Charlie Munger take questions from the audience for six or seven hours. These meetings have provided valuable advice for investors and this year was no exception. Here are 10 lessons from this year's edition:

1. Price paid determines the investment outcome (Warren Buffett)

"You can turn any investment into a bad deal by paying too much. What you can't do is turn any investment into a good deal by paying little, which is sort of how I started out in this world."

2. No magic formulas in investing (Warren Buffett)

"We have no formulas around Berkshire. We don't sit down and have ... people work till midnight calculating things and putting spreadsheets together."

3. If it's a great company, you should be happy to see lower prices (Warren Buffett)

"What hurts is that [Apple] stock has gone up ... we'd much rather have the stock at a lower price so we could buy more."

4. On investing in Amazon and Google (Charlie Munger)

"I give myself a pass (for not investing in Amazon). But I feel like a horse's ass for not identifying Google earlier ... We saw it used in our own operations and we just sat there sucking our thumbs."

5. Bitcoin is like roulette (Warren Buffett)

"Imagine people going to stick money on some roulette number ... they just do it. Bitcoin has rejuvenated that feeling in me."

6. Invest in technology only if you understand it (Warren Buffett)

"It is true that in the tech world, if you can build a moat, it can be incredibly valuable. I've not felt the confidence that I was the best one to judge that in many cases."

7. The meaning of value investing (Warren Buffett)

"You're putting out some money now to get more later on. And you're making a calculation as to the probabilities of getting that money and when you'll get it and what interest rates will be in between."

8. It is possible to be overdiversified (Charlie Munger)

"I have always been willing to own [a concentrated portfolio of] stocks. And I have not minded that everybody who teaches finance in law school and business school teaches that what I'm doing is wrong."

9. Government bonds may not be the best investment right now (Warren Buffett)

"The low interest rates, for people who invest in fixed-dollar investments, mean that you really aren't going to eat steak later on if you eat hamburgers now."

10. Beware of following the herd (Warren Buffett)

"We won't go into something because somebody else tells us it's a good thing to do. We are not going to subcontract your money to somebody else's judgment."

Wilbur Li holds a Bachelor of Commerce (Honours in Finance) from the University of Melbourne. He has worked at Unisuper (global equities) and Yarra Capital Management (equities and fixed income). This article is general information and does not consider the circumstances of any investor.

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