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Why extra super contributions tax may catch you too

Colin Lewis

Many people disregard the extra 15% tax Labor wants to impose on super contributions for those who earn more than $200,000 a year (reduced from the current $250,000). They think it does not apply to them because their salary is nowhere near this amount. But it's not just about salary. It includes much more.

Division 293 tax is broader than most people think

Labor's plan is to reduce the income threshold to $200,000 where the additional contributions tax (Division 293 tax) applies. Division 293 tax is an additional 15% tax on taxable super contributions for people whose combined income and contributions exceed $250,000 a year.

Taxable contributions are concessional (pre-tax) contributions which are employer contributions, including compulsory super and salary-sacrifice contributions, and personal contributions for which a tax deduction is claimed.

It does not apply to non-concessional (after-tax) contributions.

Income for Division 293 tax purposes includes your taxable income (assessable income less allowable deductions), reportable fringe benefits, net investment losses and rental property losses (i.e. negative gearing losses) and any amount on which family trust distribution tax is paid.

What people fail to take into account, though, is that assessable income also includes investment earnings, assessable capital gains (say from the sale of an investment property or parcel of shares they've inherited), payments on termination of employment and franking credits on dividend income.

This income together with their concessional contributions (including compulsory super) may push them over the threshold in a year and expose them to additional tax they didn't expect.

How the calculation works

Take Ron whose salary package including superannuation is $150,000 a year – i.e. $136,986 cash salary and compulsory super of $13,014. Ron makes a personal deductible contribution of $11,986 to take him up to the concessional contributions cap of $25,000.

His income for Division 293 tax purposes comprises net salary of $125,000 ($136,986 minus $11,986), interest income of $5,000, an $80,000 capital gain from the sale of a rental property during the year and a rental loss of $15,000 before the sale of that property. Accordingly, his income ($225,000) and taxable super contributions ($25,000) combined is $250,000 and he doesn't pay additional contributions tax.

(That's not a typo: the rental loss is also added on for the Division 293 calculation).

However, if Ron earns $1 more, he will pay the usual 45¢ in income tax plus 2¢ in Medicare levy. Plus now he will also pay 15% extra in Division 293 tax because this tax is paid on his taxable super contributions that take his income over the $250,000 threshold. This is effectively 62% tax on that one dollar of extra income. Ron keeps just 38¢ of what he's just earned.

And if Ron doesn't have private health insurance then there's another 1.5¢ Medicare Levy Surcharge, making it 63.5% tax, eroding even further what he takes home. This is the case for up to $25,000 of income from $250,000 to $275,000.

Ron may be able to avoid this tax as it comes down to the source of his income. If all his income came from employment, there's little he can do. However, as he's got investment income, he could consider moving his investments into tax structures where earnings aren't derived in his name, such as super or an investment bond.

Dropping the threshold to $200,000 a year will obviously capture more people in this tax net. In Ron's case, he would face a $3,750 Division 293 tax bill.

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Franking policy may increase corporate tax avoidance

Dr Rodney Brown

The heated debate continues regarding Labor's proposed removal of refundable franking credits. The primary focus is the impact of the change on retirees, SMSF trustees in pension phase and low-income earners. Attention has also been given to the policy's potential impact on asset allocation, investment in Australian companies and even the value of shares of some Australian companies.

However, one potential consequence that has flown under the radar but would indirectly impact all Australians, is the possibility for a rise in corporate tax avoidance.

The extent of corporate tax avoidance in Australia

Accusations of tax avoidance have thrust many publicly-listed companies into the spotlight in recent years. In 2014, the Tax Justice Network and United Voice accused Australian listed companies of tax avoidance on an industrial scale claiming that the federal government is short-changed by $8.4 billion annually in corporate tax revenue. A more recent study in 2018 by the National Bureau of Economic Research in the US found that in 2015, multinationals shifted roughly $15.5 billion (US$12 billion) in profits out of Australia and into tax havens. This equates to approximately $4.7 billion in lost company tax revenue to the Australian Budget.

While exact numbers are elusive, it is clear the public perception in Australia is that many companies, and large multinationals in particular, do not pay their 'fair share' of tax. And there is no other time when public perception matters most than election time.

Regulatory response from the Australian government

Australian governments have implemented several initiatives in recent years designed to combat corporate tax avoidance including the diverted profits tax, multinational anti-avoidance law, and the adoption of many of the OECD's base erosion and profit-shifting reforms e.g. country-by-country reporting. In 2018, the Australian Taxation Office (ATO) claimed its Tax Avoidance Taskforce had netted $5.6 billion in additional tax in the first two years including extra tax raised through the aforementioned initiatives.

However, despite these targeted initiatives, Australia's current dividend imputation (including full franking credit refundability) also plays an important role in curtailing corporate tax avoidance.

Role of dividend imputation system in mitigating corporate tax avoidance

The introduction of full franking credit refundability from 1 July 2000 enhances shareholder's after-tax returns and provides stronger incentives for firms to pay company tax (minimise tax avoidance) to generate valuable franking credits for distribution to shareholders.

Clearly, the change was especially attractive to resident taxpayers whose marginal tax rate is less than the statutory company tax rate of 30%, such as Australian superannuation funds in pension where earnings are tax-free, or accumulation phase, where earnings taxed at 15%. Superannuation funds are major investors in Australian listed companies and seek to maximise after-tax returns for members.

Indeed, in 2013 two UNSW academics, Gordon Mackenzie and Margaret McKerchar, interviewed Chief Investment Officers of 22 Australian superannuation funds and found that 71% claim to actively-manage franking credits as part of their overall investment strategy.

Academic research confirms impact of franking

Academic research shows that the dividend imputation and corporate tax avoidance in Australia are inextricably linked. In 2013, researchers at ANU investigated large publicly-listed Australian firms in the 1999-2003 period and found that firms distributing franked dividends adopt a more conservative tax strategy compared to firms that do not pay franked dividends. More recently, in 2018, researchers at UTS found that in the 2004-2015 period, firms paying partly-franked or fully-franked dividends are less likely to engage in tax avoidance compared to firms that pay unfranked dividends or firms that pay no dividends at all.

Recent research conducted at UNSW takes a different approach. We analysed the impact that the introduction of full franking credit refundability from 1 July 2000 had on the level of corporate tax avoidance in the years following the change, 2001 to 2004. Consistent with the results of the prior studies, we find that following the introduction of the new rule, Australian dividend-paying firms significantly reduce tax avoidance relative to foreign firms listed in Australia and Australian non dividend-paying firms. The findings are even more pronounced for firms paying fully-franked dividends.

The results of all three studies are consistent with the notion that firms undertake less tax avoidance in the post 1 July 2000 period given the presence of stronger incentives for them to pay corporate tax.

Unintended consequence?

Interestingly, there was no mention of the possible impact Labor's policy may have on corporate tax avoidance in the recent *Report on the inquiry into the implications of removing refundable credits* by the House of Representatives Standing Committee on Economics delivered in April 2019. At a time when corporate tax avoidance is especially on-the-nose with the public, this policy change has the potential to exacerbate the problem.

It is surprising that the incumbent Government has made little attempt to communicate this to the electorate and explain that this policy may undermine some of the good work it has done in recent years to safeguard revenue and preserve tax system integrity.

Possible policy compromise?

This forgotten element of the system adds to the debate and highlights one of the broader benefits of the current rules that are not related to individual investor financial circumstances. However, it does provide new weight to arguments for a modification to Labor's policy such as including a cap on franking credit refunds so that the policy intent is better achieved and to minimise the impact on low-income earners. Perhaps such a compromise would result in the best of both worlds.

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Two Labor policies facing inadequate scrutiny

Tony Dillon

The Labor Party is proposing a wide range of policy changes if it is elected on 18 May, and the consequences of most of them are uncertain.

Ironically, the heavy scrutiny on the franking credits policy may be leading to an incorrect remedy, while the subdued response to the proposal on capital gains tax ignores its potential significant implications.

This paper addresses two assumptions in the debate on these Labor policies:

1. That pension members in large pooled funds (both industry and retail funds) will continue to receive the full benefit of their franking credits, especially when the fund has a large proportion of accumulation members.
2. That the reduction in the capital gains tax discount from 50% to 25% is not worthy of much attention.

1. Trustees have yet to decide how to treat franking credits

Retirees who believe pooled retail and industry super funds are a safe haven for their franking credits may have to rethink that strategy. The argument goes that large funds with a high proportion of members in the accumulation phase pay tax on their super contributions and earnings, and this will always create a sufficient tax liability to fully absorb the franking credits allocated to the fund.

And at a whole fund level, that is true. But for those fund members in pension phase who are currently credited with an earnings rate that reflects their nil tax status, Labor's policy now becomes an issue.

Under strict super fund rules that insist all fund members be treated without bias, it is possible that fund trustees may decide they should not have franking credits allocated to their accounts because they have no tax due if Labor's policy is adopted.

The fund's equitable treatment of members provision may require pension members' earnings to be adjusted down to reflect the loss of the use of their franking credits.

Let's look at some illustrative numbers

Consider a hypothetical industry fund of size $140 billion, with approximately two million members in the accumulation phase and about 200,000 in the pension phase. The average account balance across the whole fund is therefore about $64,000. Let's also assume an average pension account balance of $200,000 and an average accumulation account balance of $50,000. That would imply a total pension phase account balance of $40 billion and a total accumulation balance of $100 billion.

Assume the same asset allocation mix for both pension and accumulation accounts of say 50% fixed interest and 50% Australian equities. Assume also a 5.0% fully franked dividend yield on equities and a fixed interest yield of 5.0%. We also assume the superannuation guarantee 9.5% of an average salary of $60,000 per member in super contributions going into the accumulation fund, uniformly across the year.

Sparing the maths details, these assumptions would yield for the pension accounts $429 million in franking credits, nil tax and an earning rate of 6.1%.

And for the accumulation accounts, $1,123 million in franking credits with total tax due $2,665 million, consisting of $955 million tax on earnings and $1,710 million contributions tax, yielding an earning rate of 5.2%.

And the earning rate across the whole fund would be 5.4%.

Total franking credits across all accounts is $1,552 million, which is significantly less than total tax due in the fund, and are therefore **fully absorbed**.

Under the Labor policy, the pension members have no tax to offset against and would lose the value of their franking credits, meaning the earning rate across the pension accounts would fall to 5.0% from 6.1%. Applying the principle of equitable treatment, 5.0% is the rate that should be credited to the pension fund accounts. That represents a sizeable 18% loss of earnings.

The earnings rate across the whole fund would be unchanged at 5.4% because the accumulation accounts are able to realise full value of the pension accounts' franking credits as well as their own. But it is currently uncertain how the benefit that would arise at the expense of the retirees' loss, would be dealt with.

The potential outcome for pension phase members

Pension phase members may be disadvantaged if the principle of fairness is applied to the fund. It has been suggested that some funds could opt to maintain the status quo and declare earnings rates assuming the pension accounts notionally realised the full value of their franking credits. But that would mean that accumulation accounts would in effect be cross-subsidising retirees by absorbing the pension accounts' franking credits on their behalf. That may be considered unfair by some trustees. And remember, their actions are under increased scrutiny since the Financial Services Royal Commission.

This may adversely impact hundreds of thousands of Australians who thought they were shielded from Labor's new policy. Retirees thinking of abandoning their SMSFs for large pooled funds should think again and at least wait until the position is clarified.

2. Labor's capital gains tax change is the sleeping giant

Labor's proposal on capital gains tax has escaped detailed scrutiny since its announcement, perhaps because it is a one-off event, and tends to be long term by nature. The electorate usually has a short-term focus.

Labor's policy is that the discount on the taxation of gains realised on assets held for longer than a year will be reduced from 50% to 25%. It will apply to all assets purchased after 1 January 2020 while investments made prior to that date will be fully grandfathered.

In 1999, the Howard Government replaced indexation of the capital cost base for inflation with a 50% discount on the capital gain if the asset was held for longer than a year. The discount became a proxy allowance for inflation, and is generous for assets held for short periods in a low inflation environment.

Get set for a double- or triple-whammy

As well as the reduced discount, Labor intends to maintain current stepped marginal tax rates indefinitely, meaning the one-off nature of capital gains potentially pushes investors into higher tax bands than otherwise would be the case.

Consider a wage earner on $50,000 who buys a property after Labor's capital gains tax policy takes effect. He sells the property in the 2024/25 year realising a gain of $200,000. After the 25% discount the taxable gain is $150,000, and total taxable income is $200,000. The investor has been pushed from a marginal rate of 32.5% to 47%. With additional tax payable due to the capital gain, of approximately $60,000.

Compare with the same capital gain under the Coalition tax regime. A 50% discount would apply to the gain reducing the taxable gain to $100,000. And with a 30% marginal tax rate spanning income from $45,000 to $200,000 under the Coalition from 2024/25, the investor's marginal rate does not change from 30%. The extra tax in respect of the gain therefore being $30,000. Just half of that under Labor.

And a high marginal tax rate not only increases the tax take. It can also have a distortion effect on the market, in affecting an investor's propensity to realise capital gains or not. For example, a high marginal rate incentivises investors to realise losses in a falling market, exacerbating that market. While in a rising market, the investor will not want to realise the gain pushing the market even higher.

When we think of capital gains tax, we often think of property, but let's not forget that it will apply equally to share investments. And this time under Labor, it is a triple whammy when investing in income-producing, growth equities. Not only is a middle-income investor hit with the non-refundability of excess franking credits when the investment is in the income-producing stage, she will also suffer the reduced capital gains discount and possible higher marginal tax rate when she eventually realises the gains.

The problem with a capital gain is that it is realised at a point in time, and taxed wholly as a lump sum, even though it has sometimes accrued over lengthy periods. In the year that the gain is realised, the capital gain can dwarf other income. It can have a sledgehammer effect.

In an ideal world the gain would be spread out and the taxation would be on an accrual basis annually, against which investment expenses could be offset. And in the case of negatively-geared investments, tax losses would

be reduced by the unrealised gains, reducing the burden on the budget and weakening the argument for Labor's negative gearing policy.

Whereas in the past, taxing capital gains on an accrual basis may have been difficult, it should be easier today using property indices. In the case of publicly-listed shares, valuations are available in the market.

Perhaps the real reform of capital gains tax needs to be considered before jumping straight to an arbitrary change in the discount rate.

Tony Dillon is a recently-retired actuary, with no affiliation with any political party. This article is general information based on a current understanding of Labor's proposals. It should be read in the context of other arguments in articles such as this and this, where executives from large funds advise they expect to refund excess franking credits.

7 strategies to manage a loss of franking

Graham Hand

In no other country in the world would a policy proposal on a subject like franking credits become a major election issue. Uniquely in Australia, three factors drive this focus:

1. The compulsory system which requires most people to put 9.5% of their 'salary' into superannuation.
2. The SMSF structure which allows individuals as fund trustees to manage their own investments in a tax-free pension environment.
3. The attraction of high dividend yields and franking credits means Australians invest in shares for income, whereas foreign investors rely more on bonds for income.

As a result, to attract shareholder support, large Australian companies have high payout ratios, whereas US companies retain profits to fund growth. Warren Buffett's Berkshire Hathaway, for example, has never paid a dividend. Around 90% of companies in the ASX/S&P200 index pay dividends at an average rate of about 4% before franking, versus only 40% of companies in the S&P500 with an average rate of about 2% with no franking.

Which is why Labor's proposal to deny franking credit refunds is a major issue for so many retirees who have set up their portfolios and retirement lifestyles in expectation of a franking refund.

The impact of a possible franking change

This article offers alternative strategies if Labor wins the 18 May 2019 election and achieves the support of the Senate in passing relevant legislation. Labor proposes an effective date of 1 July 2019, only six weeks after the election and even if the relevant legislation is not implemented until, say, June 2020, it could be backdated.

This article will not repeat the previous explanation on 'How franking credits work'.

Some people will be materially affected. An investor with $1 million in Australian shares in a pension phase SMSF earning fully franked dividends of 4.2% receives $42,000 in cash and $18,000 in franking credits, giving a total income of $60,000. The loss of franking reduces income by 30%, a massive change in lifestyle in retirement.

Here are seven strategies to consider for people facing a loss of franking credits.

1. Invest in asset classes that do not rely on franking

Nobody knows exactly what proportion of SMSF assets is allocated to Australian equities with franked dividends. Many investors hold shares directly as well as in unlisted managed funds and trusts and listed vehicles such as Exchange Traded Funds (ETFs) and Listed Investment Companies (LICs).

The SMSF Benchmarking Report from Class Limited (based on an analysis of 160,000 SMSFs) shows the following allocations between asset classes (as at 30 June 2018):

Listed shares:	**28.1%**
Cash and term deposits:	**20.6%**
Unlisted trusts:	**18.6%**
Non-residential real property:	**9.6%**
All other assets:	**7.3%**
Residential real property:	**6.2%**
Listed trusts:	**4.8%**
Limited recourse borrowing arrangements:	**3.4%**
Other managed investments:	**1.3%**

Adding the direct listed shares and domestic allocations from trusts takes the Australian share allocation to about 35% to 40%. The Class Report also advises that 52% of SMSFs are in accumulation mode (and therefore paying tax), 17% are in pension (paying no tax) and 31% are mixed, so most SMSFs are paying tax and can probably use their franking credits.

To access income from dividends and franking, pension SMSFs have become too reliant on shares such as Telstra, the major banks, Wesfarmers and Woolworths at the expense of better total returns, including capital growth. Facing the loss of franking, they are likely to allocate more to other assets where income is not franked including property trusts (A-REITs), bonds and global equities. In a survey of Cuffelinks' readers, over 50% said they will change their investments or super structure if Labor's policy is adopted.

In the Australian equities bucket, it is possible to choose more 'growth' companies where a higher proportion of the returns should come from capital rather than income. A good example among the banks is Macquarie, where the dividend is only 45% franked.

2. Add members (such as children) to an SMSF

Under Labor's proposal, an SMSF where all members are in pension mode will lose its franking credits. There is no tax payable to use the credit. However, members who are still in the accumulation phase of superannuation could be added as members of the SMSF. In accumulation, concessional contributions (currently limited to $25,000) are taxed at 15% (or 30% for those with 'adjusted income' above $250,000 a year) and earnings are also taxed at 15%.

An SMSF is a single tax entity and the franking credits generated by all members can be used to pay tax. The franking credits can be used to pay the tax of the younger accumulators.

Some financial advisers are not keen on this solution because anyone who adds their children to their SMSF is mixing the superannuation of different generations. An older person may invest more conservatively than a younger person, making asset selection in the interest of all members difficult. Older people may need more liquidity to pay pensions.

3. Qualify for a part pension to receive the 'pensioner guarantee'

This strategy applies for investments by individuals outside superannuation, as accumulation and pension super accounts are taxed differently.

Outside of superannuation, people should consider the merit of qualifying for an aged pension to retain franking credits if they are just above the pension qualification threshold.

Recipients of a government welfare pension (including full or part age pension, disability support pension, carer payment, Newstart) will continue to receive refunds under a 'pensioner guarantee'. The exception is an SMSF where a welfare recipient was not a member of the SMSF on 28 March 2018.

To be eligible for a part age pension, a homeowner couple can have combined assets (excluding the value of their own home) worth $853,000 before the pension cuts out. There are higher limits for non-homeowners and lower limits for singles (see the Asset test limits).

For a couple with, say, $900,000 in assets, it is worth doing the calculations on the merit of spending $100,000 on a home renovation (or taking a more radical and perhaps wasteful approach, a trip of a lifetime, spending up big) to qualify for a part pension, which may also come with other benefits such as a Pensioner Concession card and the recently-announced Labor policy on dental costs.

The potential result of this strategy is that a couple with $800,000 may have more income (including the part pension and franking refund) than a couple with $900,000.

Note that it is not possible to simply give the $100,000 away as such action will fall foul of the gifting rules. The maximum that can be gifted is $10,000 in any financial year and no more than $30,000 in five financial years. In addition, any gifts in the previous five years may count in the assets test. There is also an incomes test to check for pension eligibility.

We should encourage people not to rely on the age pension, and a self-funded retiree is making a strong budget contribution. Michael Rice of the actuarial firm Rice Warner has estimated that the present value of the maximum age pension for a couple who retires at 65 exceeds $800,000 in today's dollars.

4. Leave money in accumulation rather than pension

All individuals have different financial circumstances. With the assistance of a financial adviser, it's worth checking whether the loss of franking affects the best way to hold superannuation.

For example, many wealthy people start pension SMSFs to access the tax-free status, not because they need income. Yet under the rules of a pension, the SMSF must pay a minimum amount each year to the member, which rises from 4% according to age. For someone aged 55 to 59, the taxable proportion of the pension SMSF will be taxed at their personal marginal rate less a 15% tax offset. Therefore, the superannuant is paying tax on income that they might not need, and under Labor, may lose access to franking.

It might be better to retain superannuation in accumulation, where there is no requirement to draw a pension.

Furthermore, a large SMSF holding more than the $1.6 million pension cap (or $3.2 million per couple) will already have assets in accumulation phase, where earnings are taxed at 15%, creating a way to use the franking credits.

Let's say someone aged 57 has $1.6 million in a pension SMSF, which they opened to access the zero tax on a pension (and assumed they would receive franking credits). However, they are required to draw 4% or $64,000 as an annual pension which is taxed at their personal marginal tax rate less 15%. So they previously did a calculation which included:

+ save tax on SMSF assets in pension mode versus accumulation
+ receive franking credit refund (which will now be lost)
– tax on pension (which is actually converting capital into taxable income which is not good)

Under Labor's proposal, they lose the franking credit refund. The economics may change, and going from pension back to accumulation may be good because it means:

– pay tax on SMSF assets in accumulation versus pension
+ retain franking credit refunds
+ + no tax to pay on a pension.

So some people should check the numbers as they will change without a franking credit refund.

5. Transfer super to an industry or retail public fund

Where a public fund has more younger members in accumulation phase than older members in pension phase, it will probably have enough tax payable to fully utilise the franking refund. A member in a public fund may receive a different treatment of their franking credits than in an SMSF. If retention of franking credits is the major issue, these funds are worth considering.

However, there are other structural advantages in SMSFs, such as the ability to:

- Invest in almost any asset. The industry and retail funds have limited menus and do not allow direct investment in unlisted assets such as property and corporate bonds.
- Access the government guarantee on deposits, as this is available 'per entity per ADI'. A large fund is only one entity and only has one claim for $250,000 which is irrelevant given its scale.
- Borrow using Limited Recourse Borrowing Arrangements (although this is now diminished).
- Include more than one member and spread the cost.

The main reason trustees start SMSFs is for greater control over their investments, and this may not be available in a public fund. However, the 'direct investment options' offer far more flexibility.

Note also that not all public funds will refund franking in full, as covered in this article.

There is also some debate about the ability of the trustee of a large super fund to allocate a franking credit refund to a member in pension phase when the accumulation member who incurs the tax might claim some benefit entitlement.

6. Use concessional contributions to create taxable income

Concessional contributions incur a contributions tax which is included in the fund's taxable income, creating taxable income which can use the fund's franking credits.

Concessional contributions cannot be made by everyone. Generally, trustees aged between 65 and 74 need to pass the work test in the year of contribution, and those aged over 75 cannot make extra concessional contributions (although Super Guarantee and industrial award contributions can continue).

7. Transfer money from super to an individual's name

Accumulation funds are all taxed at 15% from the first dollar of income, whereas individuals have a tax-free threshold of $18,200 (or greater with the Senior Australians and Pensioners Tax Offset (SAPTO) and other tax offsets. The next personal tax scale is 19% plus 2% Medicare Levy. When an individual starts paying tax, the franking credits can be used. It might be worthwhile using this taxed component to push taxable income down to the tax-free threshold by holding investments in a personal capacity rather than in superannuation.

Like all these strategies, care and advice is needed to ensure the individual does not become subject to higher rates of tax in the personal range, as the accumulation fund would be taxed at 15%.

Conclusion

Labor's policy proposal has many hurdles to jump, but if adopted, people should check whether the current way they invest, including the types of assets and investment vehicle, is the most efficient for their unique circumstances.

Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. It is based on an understanding of Labor's proposal which is not yet legislated, and this may never happen or occur in significantly different form. Investors are advised to seek professional advice before taking action, and at least wait to see if Labor is elected and able to work with the Senate to pass Labor policies.

10 rules of thumb for investing during uncertainty

Jack Gray and Steven Hall

People tend to be uncomfortable dealing with investment decisions at the best of times. Yet current uncertainty about geopolitics, economics and sharemarket valuations can lead to a retreat from investment decision-making altogether.

Over the past year, Brookvine led discussions around uncertainty with institutional, family office and private wealth investors. Participants at the various forums generally agreed that the most effective decision-makers under uncertainty require low anxiety, patience and a tolerance of ambiguity.

They also acknowledged that **risk** and **uncertainty** are easily confused.

Measurable uncertainty is known as *risk*, about which we have a reasonable understanding. *Uncertainty* (also known as ambiguity) is reserved for the non-measurable type, about which we have almost no understanding. Uncertainty thus compels investors to rely on *heuristics (*sometimes called 'rules of thumb' or commonly-accepted rules*)* in making decisions. These refer to practical, somewhat loose rules that guide us towards the 'better' and away from the tyrannical search for the 'best'.

Most popular strategies

1. Margin of safety
Perhaps the most renowned heuristic is the margin of safety. Investopedia defines it as 'a principle of investing in which an investor only purchases securities when their market price is significantly below their intrinsic value'. It is what anchors the beliefs of investment titans like Warren Buffet and a long lineage of value investors.

The participants generally felt that the margin of safety needs to be enhanced when faced with uncertainty. It is likely that most of us instinctively feel this way. This notion was reflected in a retreat from global sharemarkets, prior to the fourth quarter 2018 downturn, by some forum participants.

2. Delaying
Delaying until there is greater certainty is another common approach. It reduces anxiety but increases the opportunity cost. Avoidance may later be viewed as an error of omission, but such errors are rarely judged as harshly as errors of commission.

3. Winning by not losing
A form of winning by not losing also appealed to participants with a pessimistic bias. You might consider the down-side case for all investment opportunities and favour the ones that are least likely to lose.

Some contrarian strategies

Some bold and well-informed investors adopt contrarian heuristics. They fix on those opportunities that are completely out of favour, and better still, are temporarily beaten down by a considerable margin. They know that the best investment opportunities often arise when you buy from a 'forced' seller.

4. Rebalancing
Some heuristics embolden contrarian behaviour. Rebalancing is the process of realigning weightings to maintain original desired allocations. It diminishes drift away from desired targets as disciplined rebalancers sell what's hot and buy what's not. Heuristics may deal with the frequency of change and the level of misalignment prompting change.

5. Conviction
Investors with a strongly-optimistic bias may seek to maximise their pay-off by investing with conviction. Heuristics that corral your best investing ideas and promote more concentrated positions amongst a smaller set of individual securities found strong support amongst the participants.

Taking a dip, or following others

6. Toe-in-the-water
The toe-in-the-water approach was familiar to many of the participants. It is useful in conjunction with delay. Often many toes remain dry, resulting in minor allocations with immaterial impact and a consequent larger opportunity cost. But, a toe-in-the-water allows an investor to prove up and grow familiar with new investments before allocating more.

7. Co-investing
Partnering or co-investing with someone who has complementary or even better skills, experience and opportunities is appropriate for investors with access to these skill sets. Investor syndicates and managed funds are the mainstay for a partnering approach.

8. Following-in
Following-in is common. Any investment opportunity will have its early adopters, fast followers, late movers and naysayers. For new and unproven opportunities, drawing confidence from the calibre of the early adopters and fast followers is common.

Diversifying, alternatives and selecting managers

9. Diversification
Heuristics regarding the level of diversification are open to debate between entrepreneurs (who made their wealth by not diversifying) and accumulators (who want to grow steadily and do not want to lose theirs). Warren Buffett famously said that:

"diversification is protection against ignorance; it makes little sense if you know what you are doing."

Diversification controls the risk that our conviction is misplaced. More rather than less is often best, more so for those lacking a prepared mind, a good investing instinct and patience.

Most participants argued in favour of more alternative investments to enhance diversification and improve returns. These include hedge funds, private equity, private lending opportunities and niche strategies in mainstream asset classes. However, there are major uncertainties around so-called alternatives. As one participant noted, alternative strategies with greater reliance on managerial skill can be fickle, so hence, as a general heuristic, you want to diversify across more strategies in alternatives than in mainstream asset classes.

10. Good hygiene in fund manager selection
Hygiene heuristics for managed funds, conceived to quickly relieve uncertainty about competing investment choices, led to range of rules of thumb:

a) a manager's own investment in their fund (meaningful is best)
b) degree of independence (prefer independently owned, unlisted firms)
c) level of client retention (high)
d) nature of their client base (long term, informed investors)
e) size of their funds under management (not excessive)
f) culture (small is beautiful)
g) focus of their activities (single discipline better)
h) turnover of their investment team (low).

Savvy investors in other asset classes, like direct real estate and private companies, often apply a set of hygiene heuristics of their own.

Past performance heuristics often rely on being able to take a quick look behind the results as numbers can lie. For example, it helps to be able to discern the positive or negative impact of a bias favouring value, growth, large or small stocks. Disaggregating results between good and bad years is another step towards making better decisions in light of annualised share portfolio returns.

A prepared mind is vital

Of course, rules and approaches may vary greatly by investment type and strategy. For all of this, a prepared mind is a godsend. This can be achieved by playing with (not planning for) conceivable, if highly unlikely, scenarios and their outcomes. It is bolstered by a critical reading of broad history and a keen awareness of investing in times past.

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Investors can reduce failures of self-control

Shane Shepherd

This is a summary of a conversation between Shane Shepherd, Head of Research, Research Affiliates, and David Laibson, Professor of Finance, Harvard University, on 11 March 2019.

Shane Shepherd and David Laibson recently discussed Laibson's research into self-control, in particular, an investor's self-control or lack thereof in making buy and sell decisions, especially in periods of market stress. The video interview and transcript are part of the Research Affiliates' *Conversations* series.

Laibson's research finds that changing the environment has proven to be much more effective than trying to talk people into changing their behavior.

Standard economic theory views people as rational decision makers and fully capable of successfully acting on their good intentions. The reality is far different. The field of behavioral economics examines how people *actually* behave and the consequences of their actions. Behavioral economics acknowledges that people can be 'imperfectly rational', and that while they have good intentions, they often have poor follow-through. Looking at economics through the lens of human behavior can produce more realistic and more useful expectations about markets and market participants.

Self-control — not always easy to exercise — plays a huge role in deciding whether to take an action that will have implications both in the present as well as down the road. Walter Mischel's famous 'marshmallow test' illustrates exactly how difficult people find giving up current gratification for potentially greater gratification later.

In Mishcel's research, the experimenter gives a five-year-old child a treat and walks away. But before leaving, the experimenter explains to the child that if he or she can wait to eat the treat until the experimenter returns, they will get two treats. Many of the children were unable to wait any length of time, while others were able wait the full 15 minutes until the experimenter returned. The children who successfully exercised self-control when left alone used a number of strategies to divert their attention from the treats.

A strategic framework for self-control

As adults, we also employ strategies to help us gain control over our instinctive responses and impulses. Laibson and his co-authors' research lays out a framework for thinking about how we can gain more self-control.

Laibson prefaced the explanation of his research with Angela Duckworth and Katherine Milkman by saying:

"I think one of the interesting failings of human civilization is the principle that, somehow, we're going to make better choices by pulling ourselves up by our bootstraps and just deploying more willpower … It turns out that other strategies are better at helping us improve our ability to self-regulate."

Laibson gave a few examples. If we hear 'Everyone reuses their hotel towels', that's a way of conveying the message that everyone is pitching in to save water by reusing their towels, and you should too. This would be a cognitive (*Ed, cognitive means involving conscious thinking*), 'other-deployed' strategy. In contrast, a situational (*Ed, situational means depending on a set of circumstances*) involving an 'other-deployed' strategy would be when the hotel asks guests to make an active choice to reuse their towels, such as either placing them on the floor or on the towel bar.

A cognitive self-deployed strategy would be a self-generated deadline. For example, you really need to finish writing a report before a meeting the next morning, so you tell yourself that if you finish by 10:00pm you can relax and watch a show on Netflix. It's the carrot on a stick approach.

An alternative approach would be a situational self-deployed strategy in which you make a commitment to an external party. Instead of promising yourself a reward for achieving the work deadline, you make that promise to someone else, perhaps your manager. A commitment to an external party creates credibility for your promise and can be a very powerful way to ensure you follow through on your goal.

Interestingly, none of these strategies involve having more willpower. Rather, they all involve taking the limited willpower humans typically exercise and enabling it to go further.

Strategies to help save for retirement

Abundant anecdotal evidence and substantial academic research suggests that many people around the world are nowhere near saving the amount they will need to provide for a safe, secure, lengthy retirement. The research Laibson and his coauthors conducted shows that **situational, as opposed to cognitive, strategies are the more successful** way to help people grow their savings.

Cognitive strategies, in which we try to talk people into saving by either explaining how important it is or telling them how many other people are saving, work to some degree, but unfortunately fall short in offering sufficient encouragement to keep up the effort.

Compulsory savings, very much a part of the ecosystem of savings, particularly in Australia, is an other-deployed situational strategy, which by its very nature is quite successful. Mandating that everyone who gets a paycheck must put some of it away for retirement is a very effective means of building an individual's savings.

Private institutions encourage savings using less-strict strategies, such as defaults. If the employee doesn't wish to participate, they can opt out, requiring an action, a conscious decision not to save.

Strategies for impulse control in market downturns

Another area that suffers from problems related to self-control is investment decision making, or specifically, the desire to sell in the midst of a market downturn. When the market begins to fall dramatically and unexpectedly, many investors are plagued by a tremendous sense of panic. The impulse is to pull out of the market, to sell in order to avoid the negative feelings of being invested during a downturn, even though on a rational level they realize selling is likely not in their or their portfolio's best interest.

The strategic framework just discussed as encouraging savings for retirement is useful in helping investors develop a plan for moderating impulsive behavior *ahead* of future market dips. Such a plan can support a more appropriate response by investors when the market takes an inevitable nosedive.

The message to investors is to resist the impulse to sell. "Sit on your hands." Laibson recommends that, during unpressured moments, investors develop a strategy of being passive and of not trying to time the market. Thus in periods of market turmoil, when everyone is rushing for the exits and the panic to sell begins to make its presence known, the prepared investor only needs to remind herself of the cognitive strategy she's developed to not overreact when the market is melting down.

Conclusion

Behavioral economics studies the ways people actually behave and applies these learnings to help people make better decisions for the long run. The recent research by David Laibson, Angela Duckworth, and Katherine Milkman explores strategies for enhancing self-control. These strategies can be either situational, which help us change our environment to have the appearance of more self-control or to make decisions easier for us, or cognitive, which are more of the educational variety.

They find that situational strategies tend to have 'more bite'. Ultimately, as Laibson points out, changing the environment has proven to be much more effective than trying to talk people into changing their behavior.

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AI is running ahead of its ethical issues

Michael Collins

In the Wisconsin city of La Crosse in 2013, Eric Loomis, then in his early 30s, pleaded guilty to eluding police in a stolen car. The judge sentenced Loomis, who had a criminal record, to six years in jail, the longer end of possible terms.

So? Well, the judge based Loomis's prison term partly on the recommendations of an artificial-intelligence, or AI, programme that uses secret algorithms to assess the risk a person poses. In Loomis's case, the Compas report showed "a high risk of violence, high risk of recidivism". Loomis appealed the length of the sentence saying he had no opportunity to evaluate the algorithms and their assessment based on his gender violated "due process rights".

The court's use of AI to sentence Loomis attracted much criticism because it raised questions about the role that 'big data' and AI are playing in everyday decisions. Expect more such controversies for society to solve as AI's rapid deployment is creating many ethical issues – a gentler way of saying AI is capable of ill as well as good.

The role of AI and algorithms in day-to-day decisions

AI is certainly causing concern. Among potential dangers, AI might be used by despots who want to enforce censorship, micro-target propaganda and impose society-wide controls on citizens. Many think the disinformation, conspiracy theories and echo chambers that AI-driven recommendations engines can promote on social media deepen social tensions. AI can be used in warfare and has the potential to make swathes of

workers redundant. AI can act discriminately or invasively. Many worry about the privacy violations surrounding the data used to train and improve AI algorithms.

Many of the concerns about AI are tied to the nature of the algorithms. People worry that society is handing over decision-making to secret software codes – essentially instructions – that have no understanding of the context, meaning or consequences of what they do. They fret algorithms are being entrusted with tasks they are incapable of fulfilling and they magnify the biases and flaws of their human coders and the data inputted. People are concerned about how algorithms can manipulate behaviour and promote digital addiction. They see they can be gamed by attention seekers.

People are tackling some of the ethical issues involved. Researchers have withheld AI because of possible misuse. Governments, notably the EU, have acted to protect privacy. The EU is developing an AI code of ethics. Companies are creating principles around AI use and setting up ethical boards to monitor its deployment. Platforms are using AI to inhibit the ability of other algorithms to spread viral extremist content. Data gatherers are better protecting user information. US tech employees are rebelling against AI's use in warfare.

Lack of concern about online data trails

But not enough might be happening to limit AI's possible harm. People seem blasé about how their online data trails are used to sway their spending and thinking. Businesses appear far more focused on generating positive returns from AI than in overseeing and mitigating the negative side effects. Autocratic states are using AI to tighten their control over media and communication. When ethical issues are raised, valid rebuttals can result in inaction. Authorities with genuine concerns appear hobbled because of the public's fondness for the cyberworld.

Be aware that AI is being deployed at a faster rate than ethical issues can be properly identified and resolved. The moral concerns encircling AI are likely to become big enough political issues in time to warrant much public scrutiny and government intervention.

To be sure, many of the ethical issues raised are broader than AI. Some of the tech's biggest ethical issues, such as gene-edited babies, are away from AI. Many of the ethical issues swamping AI are everyday ones that are as old as humans – AI is just a new setting for them.

But that fresh setting looms so large AI is bound to spark controversies, especially since AI's political weakness is that it's easy to demonise. Expect a rigorous human overlay on AI in due course. The challenge for authorities will be to limit AI's possible harm and Loomis-style controversies without suppressing its advantages.

Flawed codes

The algorithms that power AI are reams of code that can process data efficiently to assist in making parole, medical, military, work-dismissal, university-admission and many other decisions. These instructions can perform vast analysis within these narrow functions at speeds beyond human ability.

But algorithms lack many human qualities and smarts. These algorithms do not understand cause and effect. They lack common sense, emotion, imagination and senses of humour or irony. They have no free will. They can have inbuilt biases, generally delivered by the data that drives them. They can be gamed and outsmarted. The ethical issue is: How can society justify the handing over of vital decision-making to AI when it falls well short of human ability in so many ways?

The ethical cloud over algorithms is highlighted when they are set tasks beyond their design limits. 'Content moderation' algorithms that scour for inappropriate content keep much out. But they have often failed to remove all copies of an offensive video because people can alter the footage enough to outwit algorithms that can only look for earlier versions.

A wider ethical issue is whether or not AI-dependent platforms should be responsible for the content shared and viewed on their platforms, whereas now they bear little legal responsibility. Another ethical issue is whether or not private companies should be monitoring the 'cyber public square' – that private companies are acting as censors and judges of what's appropriate. And what is the responsibility of users in all this? Enough

Another ethical issue to resolve with AI is whether or not to let algorithms operate in situations with infinite possibilities (such as powering driverless cars on open roads) when, for now, AI works best in defined conditions (such as translation or, in the case of driving, keeping a car within white lines). The death of a pedestrian in Arizona by a self-driving car in 2018 highlighted how AI programs can prove fatal in uncontrolled

situations. A central ethical issue here is whether or not the hopes that autonomous vehicles might one day reduce road fatalities is worth the loss of life in the experimental stage.

Another prominent flaw of algorithms and data is that they promote the biases of code writers and data. The common problem here is that data, as a record of the past, feeds algorithms the prejudices of the past. While no one defends discrimination per se and code writers can attempt to overcome this flaw, the ethical issues require subjective solutions.

Data with gender, race and other biases and the limits on the abilities of algorithms are prompting calls for algorithms to be regulated. Companies could come under pressure to reveal their algorithms, as France is doing with those used by the government. The tech industry, however, resists such transparency, saying their formulae are intellectual property.

Such ethical issues around AI are prompting reassessments of the technology, as shown by talk of a second 'AI winter' (when research and deployment stalls), a surge in warnings of its potential harm, and by a spate of books highlighting its flaws, such as Meredith Broussard's *Artificial Unintelligence*.

While the Loomis appeal was rejected by the Wisconsin Supreme Court in 2016 and the US Supreme Court in 2017 refused to hear the case, the ethical issues it raised will be among many that surround AI as its deployment brings many benefits to society.

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