Firstlinks
a Morningstar company

Edition 407, 14 May 2021

Contents

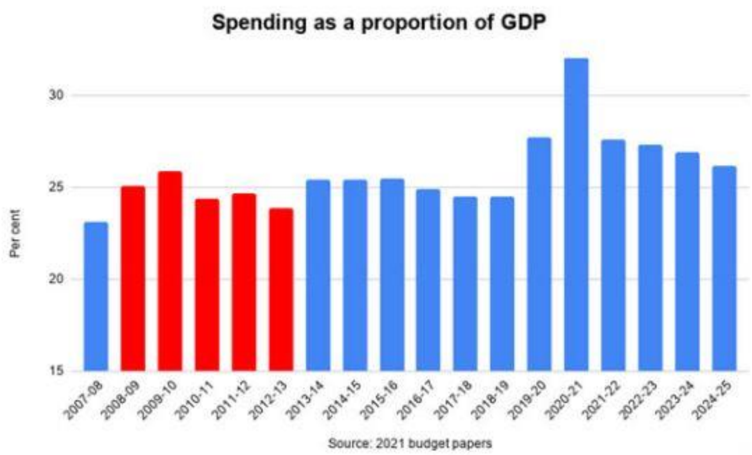
Editorial

Treasurer **Josh Frydenberg** is loving it. Two years ago, the budget was Back in Black, now it's Simply Red and the politics works well both ways. This year, he's a sugar daddy as the **Hot Chocolate** references are flowing thick and fast. *ABC TV* declared 'Everyone's a winner, baby, that's the truth'. *The Australian* featured 'I believe in miracles' on the front page, from 'You Sexy Thing'. I'm old enough to own Hot Chocolate's Greatest Hits (and I saw them live in London) and the album includes other suitable songs such as 'You'll Always Be a Friend' and 'Don't Stop It Now'.

As **Laura Tingle** said in 7.30's coverage of the budget:

"There have been three prime ministers and three treasurers in the eight years the Coalition has been in power. But until very recently there has just been one overwhelming idea driving its management of the federal budget: debt and deficits."

The momentum in Australian politics is to big governments, spending over restraint and acceptance of deficits as the new doctrine. A popular test, as shown here with Labor in red and the Coalition in blue, is the ratio of spending to GDP. In the John Howard years, it was always below 24% but now 26% to 27% is accepted, a level the Coalition criticised Labor for when 'debt and deficit' mattered.



The political policy shift is global. In the US, the balanced budget rhetoric died decades ago, but **Donald Trump** took deficits to another level with corporate tax cuts and military spending. **President Biden** is going even further as the public loves the stimulus cheques even if some higher taxes are threatened. Who doesn't like free money!

This week, we focus on major consequences of governments believing there are few limits to their spending. With the assistance of **Liam Shorte** and **Lewis Jackson,** we summarise the major budget changes and differentiate between the superannuation measures for FY2021 and FY2022. Note that this week's changes need legislation and are some way off.

Then we examine Australia's love of residential property investing, especially the willingness to buy into an off-the-plan dream in a building that will not be completed for three years. It's a leap of faith and few people know the big risks they are taking on future defects.

Meanwhile, we are seeing a tech price correction with major falls in Australia and the US. Thousands who borrowed to invest 'to the moon' are realising debt needs to be repaid. As Charles Mackay recorded in *Extraordinary Popular Delusions and the Madness of Crowds*:

"Men, it has been well said, think in herds. It will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

We are seeing in cryptocurrencies, especially **Dogecoin**, where months of favourable Twitter posts by **Elon Musk** drove up prices, that precipitous falls happen simply when he calls it "a hustle". In the first quarter of 2021, the IPOs of 300 Special Purpose Acquisition Companies (SPACs) raised US$100 billion, making a few people wealthier than they ever dreamed.

Australian share investors are far more restrained on leverage than Americans. Based on **Reserve Bank** data in Table D10, Australian margin lending into shares totalled only $16 billion in December 2020, compared with a high of $41 billion just before the GFC.

However, in the US, margin debt balances are at all-time highs, as shown, boosted by easy-to-access loans and cheap trading platforms.

Note: Figures as of March
Source: Finra

All this asset optimism makes assumptions about the favourable future course of inflation. The CPI data released in the US overnight showed prices rising by the most since 2008 due to supply chain issues and a rise in demand as the economy opens. The annual increase to April 2021 is 4.2%, higher than the consensus. While the Fed remains sanguine, the S&P 500 dropped 2% and the NASDAQ another 2.7%.

In Australia, do you feel prices are rising but we don't see it in the CPI? **Jesse Imer** explains how this happens, and it's not that prices are steady, it's the way the statisticians measure inflation.

Don Stammer draws on his decades of experience to answer one of investing's most important questions. Is all this stimulus, spending and money printing likely to have inflationary consequences? Inflation is becoming a big deal for all markets.

We then publish a surprising reveal, written anonymously but from a trusted source. The crooked **Bernie Madoff** came very close to signing a distribution deal with a major fund manager in Australia, which could have destroyed the savings of thousands of Australians. A lucky escape based on some final compliance checks avoided massive brand damage.

Although the growth of ETFs has taken them well past Listed Investment Companies (LICs) in recent years, there are about $53 billion worth of LICs on issue. **Claire Aitchison** explains one advantage LICs hold, the ability to sustain their dividends, and shows which specific LICs cover many years of future payments.

Then **Craig Day** describes how to use the higher contribution caps and a reserving policy to make extra contributions this financial year based on a little-known strategy. The detail is complex but the basic idea is simple.

This week's White Paper section includes additional budget news from **Shane Oliver of AMP Capital** with a broader coverage of the details and a short video from **nabtrade's Gemma Dale** identifying her highlights.

Favourite **Comment of the Week** came from David, who argues the impact of index funds is overstated because most people think they can outperform:

"There will always be people out there who think they can beat the market. just a few will and most won't. But just those few will inspire others to think they can do it when clearly they can't. I would say then that the number of people who clearly know they can't beat the market would be extremely small, so the impact of index funds will probably never be that great as there is a natural tendency of humans to think they far better than they actually."

Now I'm off to play the Hot Chocolate album I haven't listened to for 20 years, hoping to channel the happiness that the Treasurer is feeling this week. He's suddenly realised he has the money to keep everybody happy.

Whoyagonnacall? 10 unspoken risks buying off-the-plan

Graham Hand

If there's something strange
In your neighborhood
Who ya gonna call? (Ghostbusters)

If there's something weird
And it don't look good
Who ya gonna call? (Ghostbusters)

If you're seeing things
Running through your head
Who can ya call? (Ghostbusters)

With acknowledgements to Ghostbusters, Ray Parker Jr, provided to YouTube by Arista Records.

Buying a property off-the-plan starts as an exciting dream created by the visions of architects and designers, but it's often a world away from the harsh reality of living there a few years later. Water leaks, building cracks, noisy neighbours and old sofas dumped out the back become the 'strange and weird' ghosts facing owners after they settle on their dream.

Unfortunately, there are no friendly ghostbusters for property defects when "*there's something weird and it don't look good*".

Media reports of people queuing around the block to buy apartments launched off-the-plan are commonplace. At that stage, apartments (and townhouses and house-and-land packages) are designs subject to change, deliverable in three to four years. The buyers stand anxiously waiting for hours, eventually finding their way to a sales desk where the agent shows them a chart with lots of red dots – apartments already sold – and the buyers have a short time to make a massive commitment. It's probably the biggest financial decision of their lives and it's made based on a glossy brochure, a fancy display unit and a need to decide immediately. For example, as reported in Domain:

"A crowd of 100 eager buyers queued in the city's early morning chill from 7am on Saturday keen to snag a unit in the Infinity by Crown development at Green Square. By 10am the crowd had ballooned to 300. "We released 326 apartments and 105 apartments sold in the first hour," said Crown Group Chief Executive Iwan Sunito. "We sold $100 million worth of apartments in the first hour and $170 million by the end of the second hour. The total value of apartments sold had reached $350 million at 3pm."

Stand at the back of this queue for a couple of hours and see who can resist buying an apartment when they reach the front.

The harsh reality starts to hit you

You know little about the problems you may face when the inevitable defects surface. It is easier to replace a vacuum cleaner or fix a car under warranty than it is to remedy the defects on a multi-million-dollar apartment. The agent's job is to sell the dream, and by the time defects in the building are discovered, the developer and builder may be long gone, or indifferent to your problems.

On final inspection before settlement, you walk around your new apartment holding the original brochure, and you now see the floor plan is 'not to scale and for illustration purposes only'. Wasn't that wall supposed to be a window? The view from the balcony is of another building, what happened to the trees and water? The rooms feel small, is this apartment really 150 square metres (sqm)? Why does the kitchen bench intrude into the living room? What's that stain on the window sill … is it leaking? ... and the traffic noise is worse than you expected.

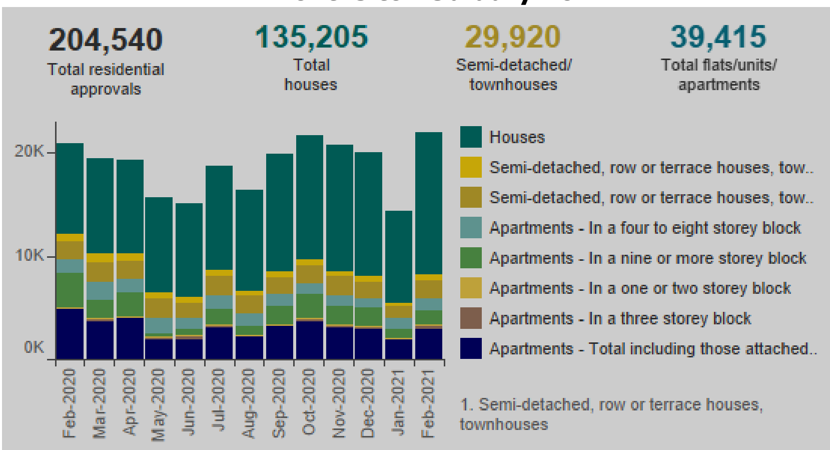
You will need a lot more than a tape measure to sort this out. Every completed apartment building has defects, and even if you arrange a building inspection before completion, many details are missed by someone charging $2,000 to walk around for a few hours.

Of course, it is better to deal with long-established developers and builders with good reputations, but don't expect them to write cheques willingly. While they want to protect their name, dealing with them can be an exhausting physical, mental and financial drag. The disaster at Opal Towers was built by Icon, a leading construction company recently appointed for the $60 million renovation of North Sydney Olympic Pool. Icon blames the engineering firm, WSP Structures, and both the developer, Ecove, and the Sydney Olympic Park Authority (SOPA) are involved in legal actions. Somewhere amid the blame shifting are the owners trying to get on with their lives in an apartment nobody wants to buy, claiming there are over 500 new defects.

Whoyagonnacall? Knowing what you don't know

There are about 700,000 apartment buildings in Australia. In the latest figures shown below, 70,000 apartments and town houses were approved in the 12 months to end February 2021.

Number of new residential buildings approved, 12 months to February 2021



Source: Australian Government, Institute of Health and Welfare

The most common defects are internal and external water leaks and structural cracks. According to a 2019 paper by property specialist, Dr Nicole Johnston of Deakin University, in a study of 212 building audit reports with 3,227 defects from around Australia:

"85% of all the buildings analysed had at least one defect across multiple locations. The result was slightly higher in New South Wales (97%) and slightly lower in Queensland (71%) and Victoria (74%). The average number of line item defects identified per building was 14 … The average number of construction systems (noting that 13 construction systems formed the classification matrix) affected by defects per building was 5.93."

With a defect hit rate of 97%, anyone buying off-the-plan in New South Wales should assume their building will have defects.

So here's Part 1 of a list to show what you don't know.

1. Who will identify the defects?

You move in but you know little about whether the building was constructed according to the approved design drawings, especially items outside the apartment such as fire protection, drainage, electrical equipment and water damage prevention. For example, a water leak at the prestigious 104-unit King & Phillip building in Sydney has delayed settlement until mid-year.

In fact, you don't even know what is your personal responsibility inside the apartment and what is the common property of the building. The front door and windows are common property, but what about exhaust fans, lights and aircon units? Will the body corporate fix faults or will you?

The first major storm is a test for any large building and you discover a couple of your windows leak. In other apartments, wet floorboards are already lifting. Some owners suspect the cladding is flammable.

Whoyagonnacall? Get ready to start arguing over who is responsible as the developer points to the builder who blames the sub-contractors. Prepare for expensive consultants' reports and special levies, and bring in an experienced legal adviser. Many problems might not surface for five or 10 years, who is responsible then?

The Home Building Act, NSW, section 18B, says:

"Warranties as to residential building work

1. The following warranties by the holder of a contractor licence … are implied in every contract to do residential building work

a) A warranty that the work will be done with due care and skill and in accordance with the plans and specifications in the contract."

The owners via the Owners Corporation (OC) and Strata Committee (SC) have two years to lodge a claim against the builder to (in the case of NSW) the NSW Civil and Administrative Tribunal (NCAT). Identifying and quantifying defects is specialist work, requiring the SC to hire engineers and construction experts.

Who will do the identification and liaison work on behalf of the owners? The Chairman of your SC is a retired 80-year-old teacher. He's a nice guy happy to run the SC for something to do, but he does not have the skill, resilience or desire to manage a major project such as this. Whoyagonnacall to do the work? Is it you?

What about the building manager, what do they do? Building managers are not a maintenance service for all owner problems. They may act as a coordination point, and while they may call the builder and ask them to fix a problem, they do not have the skills or time to monitor the work and decide if the job was done correctly. They will not manage a major dispute for you. Their responsibilities only extend to common property, but does that include your blocked drain? Who knows?

Surely you can rely on the occupation certificate, or a building certifier such as the Principal Certifying Authority (PCA). Let's put aside the fact that the certifier might be a mate of the builder and relies on them for work. The usual certification process is that each contractor is required to sign a piece of paper saying the job was done according to the contract, in both quality of work and materials. Of course the contractor signs this, but that is no security that it actually happened. Cheap wiring with flammable casing? Why not save a few dollars? The certifier inspects little if any of the actual work.

Anyway, much of what matters such as façade fixings, fire prevention, electric cabling and drainage systems is buried under years of work or located behind walls and ceilings. After six months, your shower drain is blocked with your hair because the builder poured waste cement down your drain. No certifier will predict that, but whoyagonnacall? The only way to know about many problems is when something stops working, often years later, or in an emergency when the equipment fails.

Let's say you find problems during the final inspection before making the settlement. Consider the plight of this buyer reported in [The Sydney Morning Herald:]()

"A Sydney apartment buyer stands to lose her life savings or be forced to buy into a 300-unit development that she has been warned contains major defects. Maryam Behrouz's pursuit of the great Australian dream has become 'a nightmare' after being told she must settle the $625,500 purchase in Kellyville because the building has been ticked off by a private certifier."

2. Who will fix and pay for the defects?

Who are you chasing anyway? Many builders and developers set up $2 companies for each project, and your apartment was built by Great Ocean Road 007 Pty Ltd. Whoyagonnacall to find any money there?

It's likely that the builder and developer are different companies. The developer is the owner of the project and the seller of the properties. They employ an architect, then give the plans to the builder. Often, the architect steps away from the project at this stage, so the expert who did the original design is no longer involved. Don't expect them to review the final product.

Construction is a competitive business, full of tight margins, militant unions and expensive trades. The builder studies the plans and specifications and quotes $50 million for the job on a 3% margin, hoping to make $1.5 million. The job is awarded, the developer hands over the site to the builder, who sets to work deciding how 3% becomes 6%. Welcome to cost cutting. If the developer does not employ the necessary skills to watch the builder at every stage, then the European fittings become Chinese copies, the sound proofing and insulation is thinner, the ducting runs from the kitchen over the bedrooms to reduce the distance but makes a noise when people are in bed.

Step-by-step, it's an inferior build that will be expensive to repair five or 10 years after moving in, long after any warranties have expired. Most frustrating is that the builder saved $10,000 on something that might cost $100,000 or more to fix by the time the ceiling or walls are removed.

Even if the builder and developer are well-established, major listed companies, they deal with recalcitrant owners and committees every day. They are experts on the issues while the owners are bankers, teachers, nurses, farmers and fund managers. It is familiar ground for the experts, and they bat problems out of the ground every day. You need help but whoyagonnacall?

NCAT can only adjudicate on matters worth less than $500,000, and major defects often cost far more. Next step is either mediation (more work for you), a local court or the Supreme Court. Now watch the legal and consultant bills mount up.

3. Who will enforce and manage the work?

Let's say your building is having problems with water leaking, noises between apartments and flooding in the car park, so you call in an engineering consulting firm to do a thorough audit. A special levy is needed to fund this $50,000 study of the building, which some owners are unwilling to pay. After heated arguments and lobbying, you finally push it through the SC. The building manager knows a firm (is it his mate?) who can do the audit work, and three months later, the consultant delivers a 100-page report.

What will you do with it? Hire another consultant to read it? Nobody on the SC is a builder or an engineer, and you don't have a clue what all the detail on fire regulations, building codes, minimum this and maximum that even mean. Whoyagonnacall? So you hire the consultant at $450 an hour to liaise with the developer and builder to fix the defects.

Let's be optimistic and say you eventually make progress with the builder who agrees to fix things. Whoyagonnacall to manage the project on your side? Does the consultant visit your property each time the builder turns up? The builder will do the least possible to get you off his back. He will send over a bloke with a tube of silicone to fix the water leak and claim the job is done. In the next storm, maybe six months later when the rain is heavy and the wind is in the right direction, it leaks again. The real cause is a crack in the facade a metre from the window but whoyagonnacall to find it?

A year later, with the clock ticking before the two-year deadline under the Home Building Act, you decide the builder is full of empty promises and delaying tactics. You need a specialist lawyer to advise of your rights and how to make a claim to NCAT, or is it a court? The SC Chairman is now the former SC Chairman because he never signed up for all the hassles.

If you don't do the work, maybe nobody will. It will be a stroke of luck if your SC has the resources to handle a major prosecution of a builder or developer.

Even when the work begins, how are external leaks fixed on a completed building? The scaffolding is long gone, so workers hang over the edge on ropes, 30 storeys above the ground. The men in the picture below are not cleaning the windows, they are sealing leaks. Imagine how slow and expensive this is, and neither your building manager nor consultant will know whether the job was done properly. Next time it rains, you may need to send the guys over the side again.

4. Is your new dream property even what you paid for?

The design you signed up for is subject to change. The architect gave it to a graphic designer who gave it to the developer who gave it to the builder who gave it to dozens of contractors. Then four years later after a hundred people have interpreted the plans according to their skills, budget and profit margin, you are shown the finished product.

Check the fine print in the sale contract. It allows the developer to deliver a property with a 5% variance in size. For variance, read reduction. It might not seem much, but on a 150 sqm apartment, 7.5 sqm is a smaller bathroom, nowhere to put the big screen television or the loss of half a balcony. Did the size allowance include that boxed-in column in the corner which cuts into your living room? Or the empty space at the back of the kitchen cupboards?

The value of 5% depends on the apartment. The most luxurious and expensive apartments in Sydney sell for $60,000 to $80,000 a sqm and losing 10 sqm on a 200 sqm apartment is an effective cost of maybe $800,000. Even at $20,000 a sqm, losing 5 sqm is $100,000, plus a loss of the floor space you need. A QC will tell you there is no case for the developer to answer, as you should have known when you signed the contract, four years ago.

Surely the basic design must be honoured. Then [consider this]:

"When excited first home buyer Jae Jun Kim went to inspect the one-bedroom apartment he'd bought off the plan in Sydney's CBD, he discovered something vital was missing: the bedroom. Where the wall to the bedroom and the much-lauded feature decorative glass sliding screen door should have been was … nothing.

Instead, the slick one-bedroom apartment in the new 15-storey building The Castlereagh that Kim had paid $560,000 for in October 2012 was actually a studio. He was distraught."

5. Who is on the SC and what are the strata fees?

At the first meeting of the SC, full of well-meaning neighbours, busy-bodies and amateur administrators, you will be lucky if everyone is cooperative with the same goals. There are investors versus owner-occupiers, and one group wants to landscape the grounds and the other wants the lowest fees. Will this group of people be capable of years of arguing with expert builders and developers while running a major court case?

Nobody in the room is likely to know that under the Strata Schemes Management Act (in NSW), at the first AGM of the SC, the following must be provided by the developer under clause 16:

"a) all plans, specifications, occupation certificates, diagrams ... planning approvals, complying development certificates, 'as built' drawings, compliance certificates, fire safety certificates and warranties ... the initial maintenance schedule, any interim report or final report of a building inspector ..."

... on and on it goes. Even if you are in an older building, does your SC have these documents? Do you expect the developer or builder to turn up with these if you don't demand them?

You notice someone at the SC who seems to understand how the industry works. Some builders and developers retain apartments which gives them a legal right to attend all SC meetings. They can influence the outcome by speaking forcefully about rights and obligations (although they cannot vote) and create unlimited delaying tactics. Say the SC needs to raise a special level of $200,000 to prepare a court case. An experienced advocate can make the case that it's a waste of money better spent on fixing the defects.

At the initial sales pitch, the real estate agent has an incentive to talk down the strata levies, especially when a development has a high proportion of investors rather than owner occupiers. But it is guesswork. The first meeting of the SC sets the strata fees, and you can be sure the consultant brought in to advise on the fees will bring a new dimension. You need a sinking fund to replace the lifts at some time and the entire building will need repainting after 10 years. A 24-hour concierge costs $350,000 a year, plus maintenance of the gardens and cleaning of the pool, the gymnasium and the common property. Buyers who love the idea of all those amenities need to realise they will pay for maintenance and eventual replacement.

Whoyagonnacall?

***

This is the end of Part 1 of this cheery journey through your dream purchase. For more of this joy, Part 2 next week will cover risks relating to noise, views, smells, selling and common property. We will also explore how the Design & Building Practitioners Act might work.

In the meantime, consider why it is the responsibility of the poor souls who know nothing about all this technical stuff to fight it out with the developer and builder. The owners paid a lot of money for a product and it should be delivered as specified.

Thanks to Martin Davies for assistance with this article although errors remain mine. Martin provides advice to owners' corporations and developers on addressing building defects. He works with both sides as it is in everyone's best interests to sort out the defects before they become major problems. He can be contacted on strata.projects.au@gmail.com.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any person.

Super changes, the Budget and 2021 versus 2022

Graham Hand, Liam Shorte

The 2021/22 Budget handed down by Treasurer Josh Frydenberg this week delivered many welcome changes to superannuation. However, they are subject to legislation and at best, the start date will be 1 July 2022. The changes are non-controversial, and even if there is a different party in government a year from now, the proposed amendments should stand.

But they introduce a confusion over which changes are due on 1 July 2021 and which are due on 1 July 2022. This article describes the new rules and clarifies those coming in less than two months.

Briefly on the Budget numbers:

- Real GDP is forecast at 1.25% for 2020/21, rising to a healthy 4.25% in 2021/22. However, this is not sustained with a fall to 2.5% and 2.25% in the following financial years.
- Budget deficits continue over the forward estimates, from $161 billion this year to $80 billion in 2023/2024. Not much fiscal repair there. Net debt reaches $920 billion over the four years.
- There is little expected on CPI and wage growth, at 1.75% and 1.5% for 2021/2022 pushing up to 2.5% for both in 2023/2024.

The first section below on the Budget changes is prepared by Liam Shorte of Verante Financial Planning, who writes as The SMSF Coach.

New changes from 1 July 2022

The key measures from the Budget are outlined below with some commentary and tips. I have benefited from the technical input of the SMSF Association, Accurium Technical and conversations with other professionals in preparing this content.

All measures outlined below, other than the proposed changes to legacy retirement products, are expected to commence from 1 July 2022, once they have received Royal Assent.

1. Repealing the work test for voluntary contributions

Individuals aged 67 to 74 (inclusive) will be able to make non-concessional (including under the bring-forward rule) or salary sacrifice contributions without meeting the work test, subject to existing contribution caps and existing total superannuation balance limits.

TIP: *The waiver of the work test will not apply to personal deductible contributions, so individuals aged 67 – 74 wishing to claim a tax deduction for personal contributions will be required to meet the work test (or be eligible to apply the work test exemption).*

Individuals aged 65 to 74 will also be able to use the bring forward provisions subject to the available caps and meeting the total super balance criteria. Currently, only those under age 65 on 1 July of a financial year can trigger the bring forward provision in that financial year. The measure that was originally announced in the 2019-20 Federal Budget to extend this age from 65 to 67 effective 1 July 2020 has not been legislated.

Opportunity to even up spouse balances and maximise superannuation in pension phase – Couples where one spouse has exhausted their transfer balance cap and has excess amounts in accumulation are able to withdraw and recontribute to the other spouse who has transfer balance cap space available to commence a retirement phase income stream. This can increase the tax efficiency of the couple’s retirement assets as more of their savings are in the tax-free pension phase environment.

Top up retirement savings up to age 74 – Subject to contribution caps, the new rules can help individuals contribute additional funds to super up to age 74, perhaps where they may have received an inheritance or sold an investment property.

Make your tax components more tax free by using recontribution strategies – SMSF members can cash out their existing super and re-contribute (subject to their contribution caps) them back in to the fund to help reduce tax payable from any super death benefits left to non-tax dependants. They can now do this until they turn age 75.

Tip: *There is always a cost of making changes so work with your adviser and accountant to time these strategies to minimise additional accounting costs.*

Opportunities to make spouse contributions for longer – The new rules can provide you with the opportunity to continue making spouse contributions which can not only help with equalising super between spouses, but may also enable the contributing spouse to benefit from the spouse contribution tax

2. Reducing the eligibility age for downsizer contributions

The eligibility age to make downsizer contributions into superannuation will be reduced from 65 to 60 years of age. All other eligibility criteria remain unchanged, allowing individuals to make a one-off, post-tax contribution to their superannuation of up to $300,000 per person from the proceeds of selling their home. These contributions will continue not to count towards non-concessional contribution caps.

The $300,000 downsizer limit (or $600,000 for a couple) and the $330,000 bring forward NCC cap allow up to $630,000 in one year contributions for a single person and $1,260,000 for a couple subject to their contributions caps.

Tip: *Great for people who have little super and invested in their business or property to now switch to tax-effective pensions.*

3. Relaxing residency requirements for SMSFs

SMSFs and small APRA funds will have relaxed residency requirements through the extension of the central management and control test safe harbour from two to five years. The active member test will also be removed, allowing members who are temporarily absent to continue to contribute to their SMSF. The Government expects this measure will have effect from 1 July 2022.

Tip: *Probably useful post-COVID for those working or travelling extended periods overseas and levels the playing field somewhat with APRA funds.*

4. Legacy retirement product conversions

Individuals will be able to exit a specified range of legacy retirement products, together with any associated reserves over a two-year period. The specified range of legacy retirement products includes market-linked, life expectancy and lifetime products, but not flexi-pension products or a lifetime product in a large APRA-regulated or public sector defined benefit scheme.

Currently, these products can only be converted into another like product and limits apply to the allocation of any associated reserves without counting towards an individual’s contribution cap.

There is considerable additional detail in this feature so consult an adviser if you are affected, especially to ensure you do not lose other entitlements such as the age pension.

This measure will take effect from the first financial year after the date of Royal Assent of the enabling legislation.

5. Removing the $450 per month threshold for superannuation guarantee eligibility

The Government will remove the current $450 per month minimum income threshold under which employees do not have to be paid the superannuation guarantee by their employer.

Great move and will help people get more benefit from super. If you can combine this with a personal contribution yourself or for a low-income spouse of $20 per week ($1,000 per annum) then the member may benefit from the Government Co-Contribution of up to $500 per year.

6. First Home Super Saver Scheme (FHSSS) increasing the maximum releasable amount to $50,000

The Government will increase the maximum releasable amount of voluntary concessional and non-concessional contributions under the FHSSS from $30,000 to $50,000.

Voluntary contributions made from 1 July 2017 up to the existing limit of $15,000 per year will count towards the total amount able to be released. Subject to passage of legislation, it is expected that this measure will be effective from 1 July 2022.

The Government will further make four technical changes to the legislation underpinning the FHSSS to improve its operation as well as the experience of first home buyers using the scheme.

Tip: *This is a great way to show your children the benefit of salary sacrifice and get them used to putting savings away.*

7. Improving the Pension Loan Scheme

The Pension Loan Scheme (PLS) currently allows a fortnightly loan of up to 150% of the maximum rate of age pension to boost a person's retirement income by unlocking capital in their real estate assets. It can be available for self-funded retirees who are age pension age but do not receive a social security pension. Interest is compounded fortnightly at 4.50% p.a., and any debt under the scheme is paid back when the property is sold or the person dies.

From 1 July 2022, the Government will introduce:

- No negative equity guarantee

Borrowers under the PLS, or their estate, will not owe more than the market value of their property in the rare circumstances where their accrued PLS debt exceeds their property value. This brings the PLS in line with private sector reverse mortgages.

- Immediate access to lump sums under the PLS

Eligible people will be able to access up to two lump sum advances in any 12-month period, up to a total value of 50% of the maximum annual rate of age pension (currently $12,385 for singles and $18,670 for couples).

8. Low- and Middle-Income Tax Offset extended another year

The Government announced that it will retain the Low- and Middle-Income Tax Offset (LMITO) in the 2021-22 financial year. Eligibility for the LMITO:

Low and middle income tax offset	
Taxable income	Offset
$37,000 or less	$255
Between $37,001 and $48,000	$255 plus 7.5 cents for every dollar above $37,000, up to a maximum of $1,080
Between $48,001 and $90,000	$1,080
Between $90,001 and $126,000	$1,080 minus 3 cents for every dollar of the amount above $90,000

9. Increasing the Medicare levy low-income thresholds

The income thresholds at which Medicare levy is payable for singles, families and pensioners will be increased for the 2020-21 financial year as follows:

- Singles will be increased from $22,801 to $23,226.
- The family threshold will be increased from $38,474 to $39,167.
- For single seniors and pensioners, the threshold will be increased from $36,056 to $36,705. The family threshold for seniors and pensioners will be increased from $50,191 to $51,094.

For each dependent child or student, the family income thresholds increase by a further $3,597 instead of the previous amount of $3,533.

*Thanks to Liam Shorte of [Verante Financial Planning](#) for the section above. **Liam Shorte** B.Bus SSA™ AFP is a Financial Planner and SMSF Specialist Advisor™. This is based on Liam's interpretation of the Budget announcements which may change in final legislation.*

To complete this Budget summary, here is a slide from Shane Oliver of AMP Capital summarising the major changes for 2021/2022.

2021-22 BUDGET – KEY MEASURES

- An extra $17.7bn in spending on aged care over five years
- An extra $1.7bn on expanded child care subsidies over four years
- More spending on disability, mental health and preschools
- $15bn added to the $110bn 10 year infrastructure spending program
- Spending and tax breaks to support the digital economy
- Measures to help boost women's economic security including removing the $450 per month super threshold
- More assistance for first and new home buyers and single parents via low home deposit schemes
- First Home Super Saver Scheme expanded from $30000 to $50000
- Downsizers now able to contribute to super from age 60, down from 65
- Work test for super contributions abolished
- An extension of the Low and Middle Income Tax Offset
- Instant expensing for business investment extended to June 2023
- Extra budget stimulus of $96bn in the next four years – largely spending a $104bn windfall

Changes from 1 July 2021

To recap, higher superannuation choices are coming from 1 July 2021 and apply to institutional funds and SMSFs. Caps on contributions are increasing while governance is being overhauled to promote transparency, minimise fees and eliminate poor performing funds.

1. Increase in SG

The Superannuation Guarantee (SG), the mandatory contribution made by employers, is increasing from 9.5% to 10%. SG is legislated to rise by 0.5% until 1 July 2025 when it will reach 12%. However, there is opposition to the increases due to arguments about the trade-off between current wages and future superannuation, so the increments are far from assured.

2. Increase in contribution caps

A range of changes allows most people to put more into super.

- Concessional (pre-tax) contributions are increasing from $25,000 to $27,500 per year. Concessional contributions are taxed at 15% upon entry.
- Non-concessional (post-tax) contributions (NCCs) are increasing from $100,000 to $110,000 per year. Non-concessional contributions are not taxed upon entry, although you will have already paid tax on the sum.
- Activating the 'bring-forward arrangement' allows contributions of up to three years' worth of NCCs in a single year. That is increasing alongside the NCC from $300,000 to $330,000. The three-year bring-forward maximum contribution is based on the non-concessional contributions cap at the time the bring-forward is triggered. Triggering it before July 1 will exclude you from accessing the increased cap.

3. Increase in total super balance (TSB) cap

The ability to add to super with NCCs is limited by the TSB. After the super balance exceeds the TSB, no more NCCs can be made, and the TSB cap is increasing from $1.6 million to $1.7 million on 1 July. Note there are eligibility limits depending on a person's age on 30 June of the previous financial year.

4. Increase in transfer balance cap (TBC)

The amount a peson can transfer from accumulation phase to a retirement phase pension is called the TBC and is also going up to $1.7 million for people starting a new pension. Investment returns in the pension phase are generally tax free while they are taxed at 15% in the accumulation phase.

Anyone with a transfer balance account of $1.6 million any time since 1 July 2017 is not eligible for the $100,000 increase. Those with transfer balance accounts below that previous TBC cap [will receive a portion of](#)

the increase. This calculation becomes complicated and most people affected should obtain financial advice. Those who have yet to start a retirement phase income stream before 1 July 2021 will receive the full increase. People with more than one fund, such as an SMSF, a retail fund or an industry fund, need to know that all balances are included in the transfer balance cap.

The bottom line is more contributions can be made. Chat with your financial adviser about how much of the increase you will be eligible for.

5. Changes in governance and monitoring

Changes are also expected in the way super funds and SMSFs operate because of the Government's 'Your Future, Your Super' (YFYS) legislative package. Some of these changes are still subject to industry consultation and may not clear legislation before 1 July 2021.

Many Australians have multiple superannuation accounts from previous jobs. Duplicated fees and possibly insurance policies lead to lower returns and less savings in retirement. From 1 July, superannuation account will follow members when they change jobs, and the new employer will pay contributions into the existing account.

The Government is also rolling out a new tool, 'YourSuper', to compare public superannuation products based on performance and fees. There will be annual performance tests and underperforming funds will be required to notify members and refer them to the 'YourSuper' comparison tool. Those funds that fail the test twice in consecutive years will not be allowed to accept new members.

Superannuation funds will be required to be more transparent in how they spend fund money, for example, on advertising campaigns or sponsorships. Funds that are unable to justify expenditures are in the best financial interest of the members will face penalties.

As the YFYS package has yet to pass, these proposals are subject to change.

Graham Hand is Managing Editor of Firstlinks. With thanks to Lewis Jackson, Data Journalist at Morningstar, for additional content. This article is general information and does not consider the circumstances of any person.

Why don't higher prices translate into inflation? Blame hedonism

Jesse Imer

We've been hearing non-stop news this year about supply-chain disruptions, reduced supply and higher input costs as part of manufacturing and agriculture.

We've seen this first-hand through higher prices of wheat, corn, barley, oil, timber, iron, copper, bitumen, houses, cat food etc., and yet we've only seen muted inflation data thus far, as measured by Consumer Price Indexes (CPI).

This has made us a little sceptical. Corporate revenue has been affected by higher costs and we're seeing higher costs of goods in stores and in futures markets, so why haven't we seen the higher prices reflected in CPI?

Enter hedonism, the seeking of pleasure

Hedonism refers to behaviours and interactions that are pleasure seeking, where a being will seek pleasure with respect to pain. Hedonic adjustments are utilised by economists and statisticians to measure the pleasure or utility, to derive pleasure-adjusted or utility-adjusted economic data.

Statistics bureaus use hedonic adjustments when calculating CPI, where CPI is conventionally used to measure inflation – general increases in the prices of goods and services. Sounds strange doesn't it?

We commonly use CPI to measure inflation, but we aren't measuring raw price changes – we're measuring the pleasure-adjusted or utility-adjusted price changes, which can be vastly different.

In fact, the result over the past 30 years has been a massive differential between real price movements and hedonic-adjusted price movements.

This should enrage anyone who receives a defined benefit payment, or anyone working in industries under collective bargaining agreements that increase wages in line with CPI, rather than real-world inflation.

A hedonic adjustment example

You have a bag of M&Ms that contains 100 little chocolates and costs $1 per packet.

Mars Inc. (the producer of M&Ms) finds a way to fill each bag with 110 M&Ms and raises the price to $1.10 per packet.

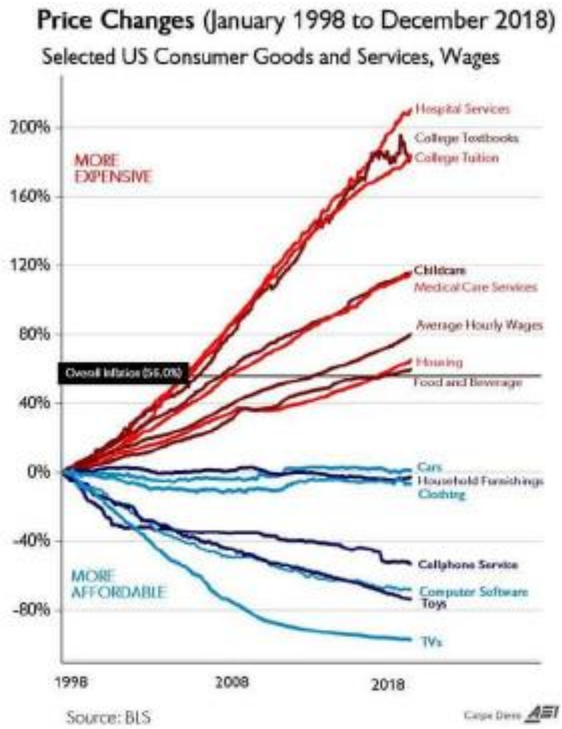
Using a hedonic adjustment, we would adjust the $1.10 bag back down to $1.00, as each M&M only costs 1c each. Therefore, cost of living has gone up by 10% ($1.00 to $1.10), but the hedonic-adjusted price has not changed ($1.00 to $1.00).

Hedonics in practice

Looking at how statistics bureaus use hedonic quality adjustments, it's obvious they track some sort of quality or total utility metric, over time, with varying assumptions.

This is the only way that they can realistically account for car prices going sideways, or state that TV prices have declined 80%, when in raw price terms, prices are generally higher.

Take for example the price of a standard 1990 Honda Accord, that cost US$12,000 at the time, where the 2020 version costs US$25,000 now.



Source: US Bureau of Labour Statistics (BLS), BLS and American Enterprise Institution (AEI)

Sources: LHS image; Wikipedia // RHS image; carshowroom.com

Or for another example is a Ford Mustang, which cost US$9,000 in 1990, or US$27,000 now.

Sources: LHS image; Fordauthority.com // RHS image; carthrottle.com

Now, a non-statistician would simply derive the price differential between the two to calculate the price rise, i.e. Honda Accord price has increased 208%; Ford Mustang price has increased 300%.

However, that type of analysis would not pass at a statistics bureau, where they would adjust the price lower, to account for the increased utility (or pleasure) that the 2020 model has compared to the 1990 version.

This is a complex equation based on assumptions of utility regarding GPS, ABS, better fuel consumption, computer assist etc. For the mathematically minded, hypothetical models for car prices would look like this:

<u>Raw-price change:</u>
Log(price) = Beta1 + B2(2020 model price) – B3(1990 model price)

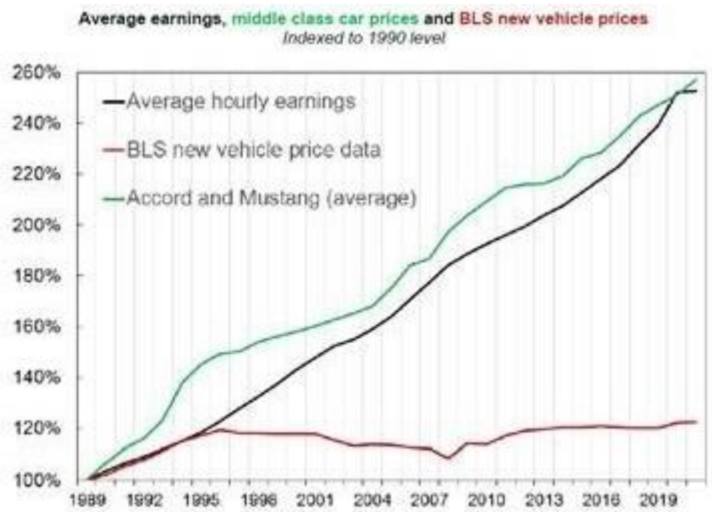
<u>Hedonic-adjusted price change:</u>
Log(price) = Beta1 + B2(2020 model price) – B3(1990 model price) + B4(GPS) + B5(computer assist steering) + B6(fuel consumption) + B7(engine capacity) + B8(trunk capacity) + e

The hedonic-adjusted price has a lot of assumptions underpinning the price change, which may not hold in reality, depending on the different car manufacturers and models.

As such, the US Bureau of Labour Statistics (BLS) records that US new vehicle prices have gone sideways these last 30 years (red line), rather than up 200-300% (green line).

Not a cost of living index

This is why CPI no longer reflects costs of living as measured by consumer spending. It reflects the cost-adjusted price based on the utility or pleasure we receive from advances in technology.



Source: BLS, HSBC

This may be seen as a BETTER measure for our economic prosperity, but it doesn't help any consumer when central banks look at inflation data at 'low' levels of 0-2%, when really the nominal figure is far higher.

Alternative measures of inflation

The failings of CPI have been well known for decades already, where the problem isn't the methodology, but how we use it.

CPI isn't broken – it fairly accurately measures utility-adjusted changes in prices. But what we shouldn't be doing is using CPI to benchmark wages and salaries or superannuation benefits.

This has given rise to other measurements, which are slowly gaining alternative popularity. A favourite of mine is called PriceStats, which collects daily online price data on over 5 million different products sold by hundreds of retailers across more than 70 countries.

This data mainly covers goods including food and beverages, clothing, energy, healthcare, real estate, furniture and electronics – the vast majority of household expenses.

The [RBA has looked at the methodology before](), which they noted includes 'volatile' items such as food and energy.

This is laughable, as why would we ignore key components of household spending such as food and energy, simply because they're volatile? These items and their corresponding prices are a key part of life for the majority of the world.

Below is PriceStats measure of Australian inflation (orange) versus the ABS Consumer Price Index (blue).

Source: Pricestats, State Street

You may notice that PriceStats' measurements consistently reflect higher inflation than CPI, over the past five years. By PriceStats' gauge, Australian inflation is already well within the RBA's 2-3% target band, whereas by CPI, we're languishing well below at 1%.

And if we make the same comparison in the USA, PriceStats is more closely related to BLS CPI, though has already tracked higher in 2021 where there is a growing disparity.

It's worth remembering that PriceStats takes daily measurements of inflation, which are released three days later, whereas the ABS records inflation quarterly, which is released nearly two months after the end of the relevant period. i.e. Q1 2021 (Jan-Mar) inflation data was released in late April 2021.

This is why PriceStats is suitable for central banks to measure ongoing inflation, lest they be caught well behind the inflation curve, which seems to be happening in the US already.

Source: Pricestats, State Street

Preservation of genuine purchasing power

As investors, an erosion of our purchasing power is the antithesis of our goals. We seek to preserve the value of capital, and where possible and applicable, increase the value of said capital.

The under-measurement of CPI is reason enough to be aware of inflation impacts that increase costs of living, where if there is not a subsequent appreciation in financial asset prices, our purchasing power may be eroded.

This is the reason why we seek investments for our clients that have a direct relation to higher real-world prices, such as inflation-linked bonds, timber, precious metals and soft commodities.

Jesse Imer is a Fixed Income Investment Strategist at [Mason Stevens](). The views expressed in this article are those of the author and are subject to change. Mason Stevens is only providing general information only. You should consider this information, along with all your other investments and strategies when assessing the appropriateness of the information to your individual circumstances.

Should investors brace for uncomfortably high inflation?

Don Stammer

In February and March 2020, the COVID pandemic caused a quick and deep plunge in global economic conditions and created widely held expectations of a severe and long-lasting recession. Investors panicked as average share prices dropped by more than a third in five weeks and interest rates fell to record lows.

Governments and central banks soon eased policies on an unprecedented scale. Many businesses found ways to cope with the effects of lockdowns and social distancing. Then the discovery and mass production of vaccines further raised economic confidence, particularly in China, the US and Britain.

As a result, the global economic slump was not only sudden and steep, but it was short-lived and uneven. Many countries are experiencing strong rebounds. Forecasters including the International Monetary Fund expect global growth of 6% over 2021, the fastest rate yet recorded in a calendar year. Employment is picking up quickly. Share prices have climbed to record highs.

Lessons from the recession, the panic and the rebound

Despite the abundance of negative comments from the many naysayers, global growth has resumed and accelerated. We saw the deepest and narrowest V-shaped slumps yet experienced in GDP, jobs, consumer spending and average share prices. Once again - as happened in 2008, 2000, 2001, 1987, 1974, 1960 and 1952 - the combination of gloom, despair and financial crisis proved to be a time to buy quality shares cheaply and a terrible time to sell them.

Alas, many investors will still not have that lesson front-of-mind when the next financial crisis comes along.

Of course, there’s a lot to worry about. Mutations could seriously diminish the effectiveness of vaccinations. Case numbers and deaths are increasing in many developing countries. Europe is dealing with third and fourth waves. Valuations are stretched. And, over time, the highly stimulative fiscal and monetary policy could leave a new set of problems in their wake, among them the high level of debt and inflation.

It’s harder framing an investment strategy now than a year ago

Many equities now have stretched-to-expensive valuations, especially in terms of price to earnings (P/E) multiples. In my view, low interest rates and accommodative monetary policy will support a few more quarters of strong share prices despite today’s stretched valuations.

The combination of abundant liquidity, near-negligible interest rates and market momentum is producing froth, failure and over-pricing, including for digital currencies, Gamestop, Archegos, Tesla, and the huge gains investors now expect when companies list. At times, correction of the excesses in some parts of the market will likely damage investor confidence across the board.

Investors also need to consider whether the huge fiscal boosts will be sustainable or will they end in write-offs, defaults, and fiscal cliffs. Will the huge budget deficits remain for decades and push interest rates to high levels, or will we see the return of uncomfortably high inflation?

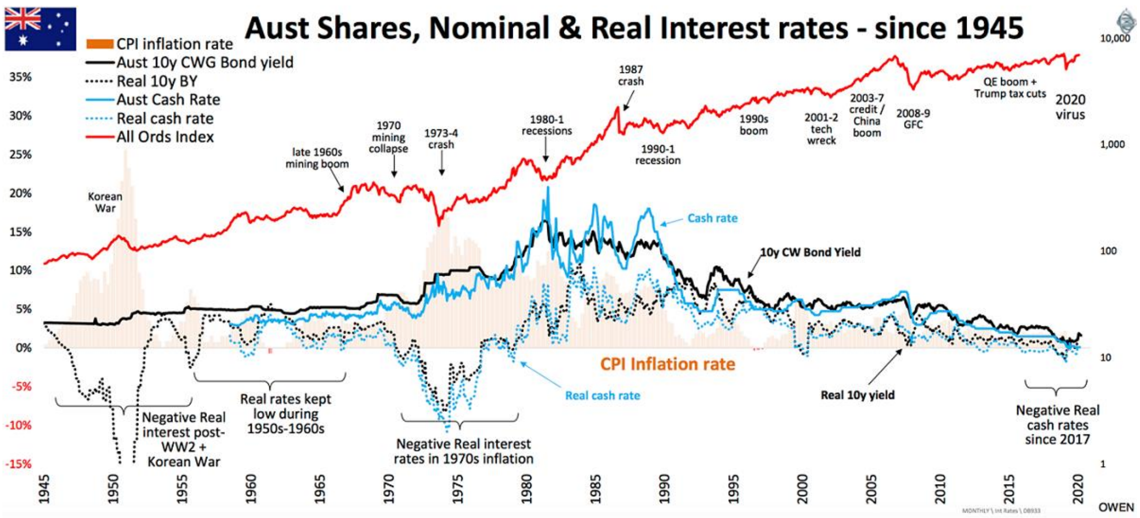
In my view, there’ll be urgent need to start winding back the massive budget deficits in a year or two.

Also, there’s the parallel question of whether the super-low interest rates and unconventional monetary policies are sustainable. The US and Australian central banks say they’ll keep interest rates at negligible levels 'until 2024 at least', and have maintained this ‘guidance’ even as economic growth has accelerated, jobs growth has surprised on the high side, and some shortages of labour have re-appeared.

For the first time in years, inflation is a risk

For at least a decade, inflation has been negligible, and stubbornly lower than most central banks have been targeting. Reasons include globalisation, technological change, the impact of the GFC on inflation expectations, and slow rates of increase in wages. Relatively few investors now have direct experience of how quickly inflation can change or the costs and uncertainties inflation can generate.

Investors under 50 years old might like to learn about the courses inflation has taken in the US and Australia since 1945 from this informative graph prepared by my colleague, Ashley Owen.



Last year, the risk of inflation returning, even over the the long run, was seen as minimal, mainly because of the pandemic-led global recession.

In recent months, bond investors have revised upwards their expectations for inflation. In my view, we'll see further upward revisions in anticipated inflation in the next year or two. The chart shows an important measure of what US bond investors expect annual inflation will be in the coming decade. This measure of inflation expectations is derived from the market pricing of US bonds. Specifically, it's the gap between the market yield on a conventional 10-year US bond and the market yield on a 10-year US bond that has its principal and interest adjusted for inflation.

In April 2020, the average US bond investor expected inflation to average 0.5% a year for a decade. That expectation has since risen to 2.4% a year. Expected inflation in the US now exceeds the yield on a 10-year conventional bond (which at time of writing is 1.6%), suggesting an investor buying a 10-year US bond is looking at a negative real return over the life of the bond.

This real return would be even lower were average inflation to exceed 2.4% a year over the decade, or if the investor was to sell the bond prior to its maturity after market interest rates had increased.

What causes inflation?

The key influences on inflation are summarised in the following list, though in practice they interact:

- Demand influences in the overall economy or in key sectors.
- Cost influences, including wage increases, rises in commodity prices or government taxes and charges.
- In general, rising productivity helps to constrain inflation.
- Competition and technical change. Globalisation has helped to check inflation, and so has the internet, which makes it easier for buyers to compare prices and shop around.
- Inflationary expectations, which both reflect inflation and cause inflation.

The outlook is for rising inflation

In my view, inflation in the US and Australia will likely appear contained or benign for another year or so, but then climb to between 3-5% in 2024, as the net outcome of these influences:

- Another year or so of above average economic growth, fuelled by large budget deficits and highly accommodative monetary policies, bringing about a quickening in wage increases and enabling some firms to raise selling prices.
- Both the US and Australian central banks will tolerate inflation settling above their target levels for a time as they focus on actual inflation, not forecasts for inflation. Most important, both monetary authorities are looking to achieve a significant reduction in unemployment and would like to see modest increase in average wages.
- Commodity prices are at high enough levels for some commentators and investors to refer to the return of the 'super-cycle' in the demand for many commodities.

The implications

Provided vaccination programmes and confidence are not seriously affected by mutations of the virus, it will soon be time for governments and central banks to reduce the scale of their policy boosts if the world is to avoid severe economic disruption in a few years' time.

In the next year, we could see a kick up in inflation and inflationary expectations, pushing bond yields a little higher and further signalling the end of the bull market in bonds that's ran for 30 to 40 years.

Don Stammer has been involved with investing for many decades as an academic, a senior official of the Reserve Bank, an investment banker and the chairman of nine companies listed on the ASX. He is currently an adviser to Stanford Brown Private Wealth. This article is general information and does not consider the circumstances of any investor.

Revealed: Madoff so close to embezzling Australian investors

Anon

Editor's note*: Firstlinks has never published an article anonymously before, but while we cannot reveal the source of this piece, it is known to us and we consider it impeccable.*

In debating whether to publish, we felt encouraged by the decision by Peter Singer and colleagues as reported in The Conversation:

"Philosophers Peter Singer, Jeff McMahan, and Francesca Minerva have announced a new academic outlet, the Journal of Controversial Ideas, as an "open access, peer-reviewed, interdisciplinary journal specifically created to promote free inquiry on controversial topics," it will give authors the option to publish their work under a pseudonym "in order to protect themselves from threats to their careers or physical safety.""

In the same spirit, confident in the source, we are publishing this informative piece without implicating anyone.

***

In 2007 Bernie Madoff's fraudulent hedge fund came perilously close to being distributed by a major Australian wealth manager. Sensible minds (just) prevailed and the distribution deal was aborted. A year later the largest hedge fund fraud of all time, a US$65 billion Ponzi scheme, was exposed.

This article, which for obvious reasons must remain anonymous, is a reminder that financial institutions, just like retail investors, are vulnerable to fraud. Financial institutions have their own set of agency issues and behavioural biases which need to be managed.

Distribution of the funds of external managers

In the finance industry, distribution is king. The logic is that it doesn't matter how good your product is, if it doesn't sell, it's not worth having. Even if you argue that money will eventually find its way to quality investment products, there is a shorter-term imperative that demands businesses maximise their short-term return on equity.

Look at the CEOs of most wealth managers. Many come from a distribution rather than a specialist background such as investments. This is not a bad outcome by any measure: an all-round suite of skills is required for a CEO to succeed and a successful grounding in distribution provides many of those skills.

It is common for wealth managers to distribute externally managed funds. This practice has existed for decades and can take many forms. A simple contractual arrangement is known as a third-party distribution arrangement while a more integrated relationship could be described as a partnership model. Another model is the white label approach, commonly used for global sectors, whereby a wealth manager outsources the asset management of their own branded product to an external manager.

Third-party distribution decisions bring different payoff profiles to wealth managers compared with the outcomes realised by retail or institutional investors. Performance will impact the asset-raising prospects for the wealth manager while directly impacting performance outcomes for end investors. Non-success of a third-party distribution arrangement represents an opportunity cost more than any significant financial cost.

Fiduciary responsibility and fraud … enter Madoff

It is only in the case of a fraud that both wealth managers and investors experience extreme pain. For wealth managers, their brand may be irreparably damaged and there is an issue of compensation. For investors, there is a performance write-off and reputational damage if the investor is an institution, such as a super fund.

There are many agency issues and behavioural biases which exist in wealth management. The agency issue centres on the degree to which staff view themselves as fiduciaries or renters of the company's brand and scale. Some of the behavioural biases include confirmation bias (tendency to ignore contrary information to their view), herd mentality (blindly follow and copy others), and a framing bias (where the narrative may distract from the facts).

So how does Bernie Madoff come into this story?

One of many tactics used by Madoff was to allow other firms to distribute his hedge fund through select third-party relationships. This added further credibility to his name: investors take comfort from the assumed due diligence undertaken by the distributor.

A major Australian wealth manager came perilously close to entering a distribution arrangement with a respected US-based third-party distributor. The major attraction: access to Madoff's hedge fund which had enviable performance, a legendary reputation and limited capacity, some of which this distributor had exclusively reserved.

What a coup to be able to partner with this group! It could really make someone's career.

The business case was straightforward: exclusive access to a legendary hedge fund and an attractive distribution fee.

How to garner business case support?

Here's where big institution politics came into play. At the time there was an unofficial ideological power struggle between distribution and investments. The business case was selectively shared with 'friendlies' before being distributed to the broad executive group. There was significant momentum behind the business case by the time key questions were asked regarding the investment integrity of the underlying investment managers.

One investment executive engaged an independent consultant to provide an initial investment opinion on the suite of funds offered by the US third party distributor, including Madoff's.

Madoff never cooperated with the due diligence processes of any investor but he had many established strategies to attract clients, including:

- access to exclusive IP (intellectual property) which couldn't be shared
- his previous career successes, where Madoff had been heavily involved in broking and software
- connections and implicit endorsement from the sheer weight of investors and capital invested in the fund, and
- exclusive distribution rights, as others were ready to take your spot.

The consultant report raised concerns that something didn't feel right, but without full due diligence access it would have been near impossible to claim that such a large and famous hedge fund manager was a fraud.

A fine balance tilted the right way

The decision was finely balanced, but it was decided to *not* proceed. I'll never know to what degree the decision was political or objective. All I can say is that I am forever glad the right decision was made and that Madoff's Ponzi scheme never managed to defraud Australian investors.

What's fascinating is that no one did anything wrong. It is healthy for employees to propose new business ideas. The processes worked, and the agency issues and behavioural biases were managed.

Just.

This article is published anonymously but from an exemplary source as a warning that even when dealing with the biggest names in the industry for what looks like a sure profit, great care and due diligence are required.

How long can your LICs continue to pay dividends?

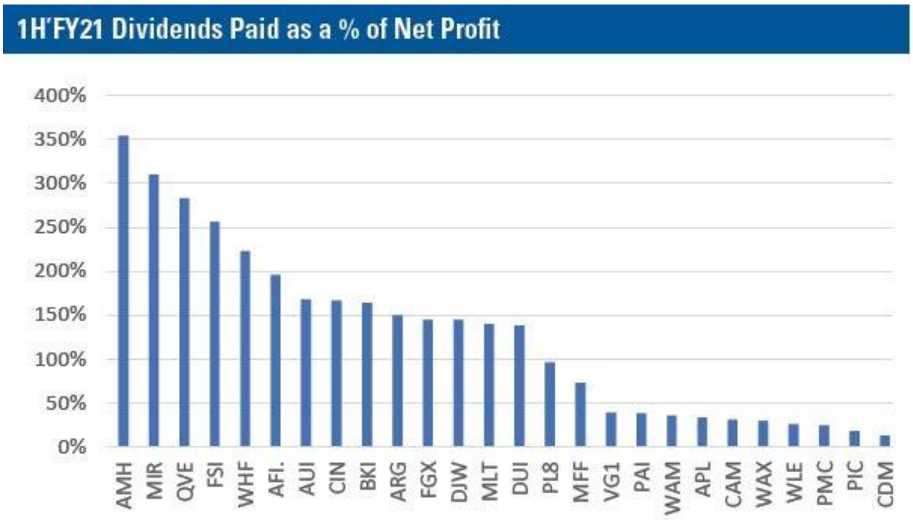
Claire Aitchison

With reporting season well and truly behind us, we thought we'd take a look at the state of Listed Investment Company (LIC) balance sheets and their dividend coverage.

The company structure of LICs allows them to retain earnings and regulate the payment of dividends in any given year. This is an advantage LICs hold over trust structures. As a company, they can transfer after-tax profits to their dividend profit reserves as a prudent measure to improve the capacity to pay future dividends, consistent with forward policy guidance.

Some LIC dividends draw on previous reserves

With an estimated overall 25% decrease in dividends paid by ASX companies over 2020, it is unsurprising that in in the first half of FY21, most equity LICs paid out more in dividends than they reported as net profit, thereby creating payout ratios greater than 100%, as shown below.



Source: Iress, IIR

We see that many of the LICs in our Australian Shares - Large Cap and Mid Cap sectors that relied on dividend revenues had payout ratios greater than 100%. However, LICs that rely more heavily on capital gains to generate returns or had global exposures were able to book realised gains to boost their net profit and thereby reduce their payout ratios.

While payout ratios of more than 100% are clearly unsustainable in the long run, some LICs have the ability to tap their retained profits/reserves to make up the shortfall, while others elected to prudently reduce their dividends to reduce the burden on their cashflow and balance sheets.

How many years of dividend coverage do LICs hold?

To check the sustainability of LIC dividends, we look at how many years LICs in each category could maintain current dividend levels given the latest reported retained earnings/profit reserve.

On average, the Australian Large Cap category has 3.2 years of dividend coverage. WHF and FSI have the greatest number of years of dividend coverage, at 8.1 years and 6.9 years, respectively, if they were to maintain the current dividend amount. Both these companies were able to draw on reserves to maintain and in the case of WHF increase the dividend throughout the volatility of 2020.

TOP, ECP, OZG and CIN all have in excess of 15 years' dividend coverage. Taking these four outliers out, the Australian Mid/Small Cap category has an average of 5.3 years dividend coverage.

There are only three LICs with less than two years of dividend coverage in the category (WAM, FGX and QVE). LICs focused on the smaller end of the market are more likely to rely on capital gains for the payment of dividends with lower levels of income typically generated through the portfolio. A strong first half of FY21 in the markets saw some LICs increase their profit reserves and boost their coverage ratios.

The Blended LIC category has a healthy level of dividend coverage as a group, with PIC having the lowest level of coverage at 2.8 years. HM1 paid an inaugural interim dividend for FY21. We have assumed the company will maintain the dividend for the final dividend for the purposes of this analysis. CDM's portfolio performed strongly in the first half of FY21 which saw the profit reserve increase substantially and allowed for the company to maintain its dividend.

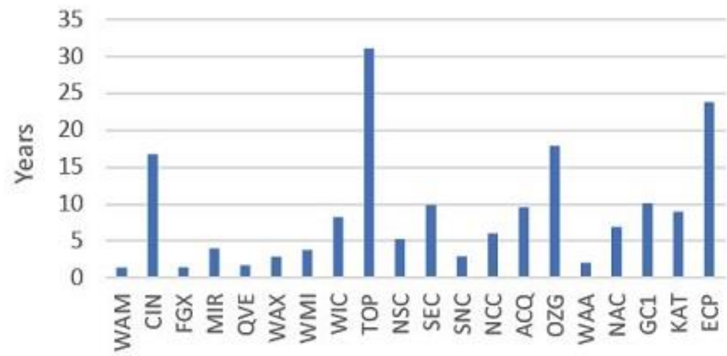
The International Shares-Diversified LIC category has a reasonably healthy level of retained earnings/profit reserves as a group. MFF and VG1 have the greatest level of coverage. The gains in VG1's portfolio saw a significant increase in the profit reserve and allowed for the company to increase its dividend. PIA, WQG, FPC and PAF all have dividend coverage of 9+ years based on dividend declared for the CY2020.

In the Other category, LSF and ALF both have healthy dividend coverage. LSF paid and inaugural interim dividend and is yet to pay a final dividend so we have calculated the dividend coverage level based on the company maintaining the interim dividend amount. In the event significant franking credits are generated, we would expect the company to start paying out a greater amount of retained earnings as dividends.

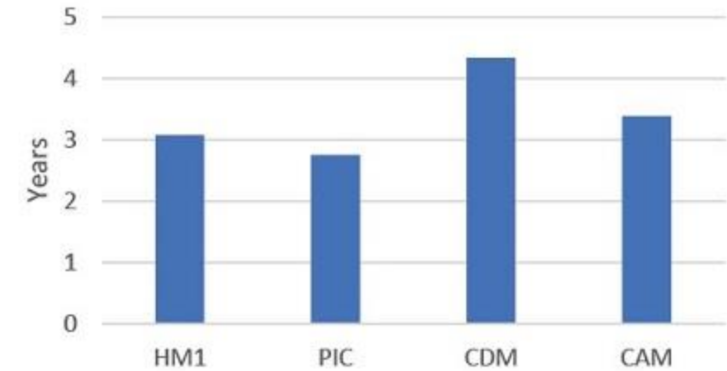
Relevance for a steady income stream

In summary, the level of dividend coverage should be considered by investors seeking a steady income stream. For those LICs that have many years of coverage, investors can be confident that there will be reduced volatility in their dividend income.

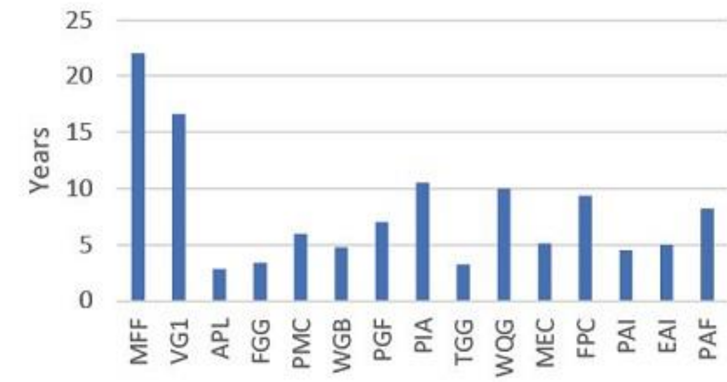
Australian Shares - Mid/Small Cap



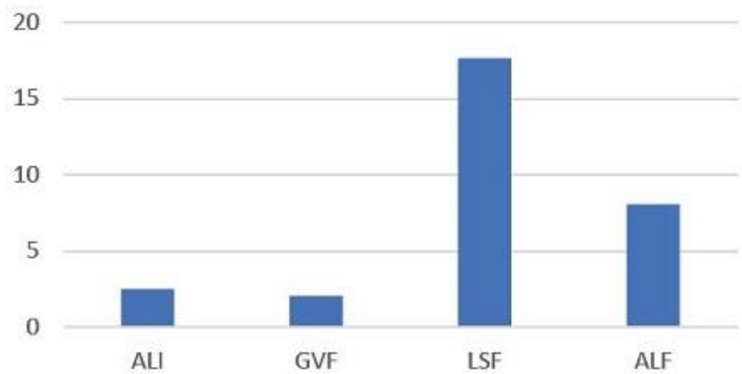
Australian/International Shares - Blended



International Shares - Diversified



Other (Specialist and Absolute Return)



We note, companies will often seek to frank dividends to the maximum amount possible and therefore the extent of dividends may be impacted by the level of franking credits available. On the other hand, those LICs with a lower level of coverage may be susceptible to a reduction in dividends in the event the portfolio does not perform to expectations.

Claire Aitchison is Head of Equities & Funds Research at Independent Investment Research. This article is general information and does not consider the circumstances of any individual.

How SMSF contribution reserving can use the higher caps

Craig Day

Under superannuation regulations, the trustee of a superannuation fund must allocate any contributions made for a member to their account by no later than 28 days after the end of the month the contribution was received (in fact, the trustee can allocate within such longer period as is reasonable in the circumstances).

This means where a member makes a contribution, whether a concessional or non-concessional contribution, in June, the trustee will not be required to allocate the contribution to their account until 28 July in the following financial year at the latest.

However, this raises the question – in which year should a contribution count against the relevant contribution cap? Is it in the year the member made the contribution or in the year the trustee allocated the contribution (if different)?

Contribution reserves and the contribution caps

In 2013, the ATO answered this question by confirming a concessional contribution made in June in one financial year that is allocated in the following financial year (by 28 July), counts against the member's concessional cap in the year it is allocated.

In addition, the ATO confirmed that a personal contribution made in June will be deductible to the member in the year they made the contribution, regardless of when it was allocated. (See Example 1 on ATO website page "Request to adjust concessional contributions".)

Contribution reserves and concessional contributions

Therefore, like the non-concessional bring forward rules, the use of a contribution reserve strategy could effectively allow an SMSF member to bring forward up to one year of their concessional cap into the current year to maximise their deductible contributions but without causing them to exceed their concessional cap.

For example, taking into account the increase in the concessional cap to $27,500 on 1 July 2021, a contribution reserving strategy could allow a member to make and claim deductions for personal contributions of up to $52,500 (assuming the member does not have any unused concessional contribution cap amounts they could contribute or are ineligible to use the catch-up concessional contribution rules) in 2020-21 without causing them to exceed their concessional cap.

The only proviso is that the member must make a personal deductible contribution of $27,500, in June, which the trustee then allocates to their account in the following financial year by 28 July.

However, in this case, it will be important to note the member will have fully utilised their concessional cap for the next year (2021-22), and will not be able to make or receive any concessional contributions in that year without exceeding their cap.

Contribution reserves and Division 293 tax

Assuming the ATO takes the same approach of assessing contributions in the year of allocation for both contribution caps and Division 293 tax purposes, a contribution reserving strategy could also reduce the amount of a member's income for Division 293 tax purposes and result in a member not having, or having a reduced, Division 293 tax liability in a year. (Note: Members wanting to confirm this may wish to consider seeking legal advice or applying to the ATO for a private binding ruling.)

For example, if the member in the above example had assessable income of $275,000 in 2020-21, their income for Division 293 purposes would be assessed as $247,500 ($275,000 - $52,500 + $25,000) after taking into account their deduction and low tax contributions. Given this is less than the $250,000 Division 293 tax threshold, they would not incur any additional 15% tax liability on their concessional contributions in that year.

However, it will be important to remember the $27,500 contribution allocated in 2021-22 will count towards the Division 293 tax threshold in that year. As a result, this could cause the member to have a Division 293 tax liability in that year as they will not also be able to claim a deduction for their contribution in that year.

For example, assuming the member's assessable income dropped to $250,000 in 2021-22, their income for Division 293 tax purposes would be assessed as $277,500, and they would be subject to an additional 15% Division 293 tax liability on $27,500 of their concessional contributions.

Contribution reserves and non-concessional contributions

It is important to note that TD 2013/22 only refers to concessional contributions. However, the same logic should also apply to non-concessional contributions. Therefore, a non-concessional contribution made in June in one year that is allocated in the following financial year by 28 July, will count towards the member's non-concessional cap in the second year.

The main advantage of a non-concessional contribution reserving strategy is that it allows a member over age 67 who is still working to bring forward a non-concessional contribution into a year that they satisfy the work test.

For example, the use of a contribution reserving strategy could allow a member over age 67 who works full or part time, but who plans to retire by the end of the financial year, to make additional non-concessional contributions of up to $110,000, in June, which the trustee could then allocate in early July in the following year.

However, it's worth noting a contribution reserving strategy will not assist a member to make a non-concessional contribution under the bring-forward rules in one year where they would not otherwise qualify to use the bring forward rules in the following year because of their age.

For example, a contribution reserving strategy would not assist a member turning age 65 before the end of this financial year (2020-21) to make a non-concessional contribution of up to $330,000 in June 2021, on the basis it would then be allocated in the following financial year by 28 July, as they will not qualify to use the bring forward rule next year due to their age. (Note: the age at which a person can make a contribution under the bring forward rule is proposed to increase to age 67 from 1 July 2020. However, at the time of writing the Bill to implement this change has not yet become law. They will not qualify to use the bring-forward rules in 2021-22 as they were not under age 65 at any time during the year.)

In this situation, the maximum amount that could be allocated in 2021-22 without causing the member to exceed their non-concessional cap would be limited to $110,000. Therefore, the member would be better off triggering the bring-forward rules by making non-concessional contributions of up to $300,000 this year.

It should also be noted that where a member would be eligible to trigger the bring forward rules in both years, the only benefit of applying a contribution reserving strategy this year would be that it would allow a member to make a non-concessional contribution of up to $330,000, a maximum of 30 days earlier than they would otherwise have been able to.

Practical issues

Before implementing a contribution reserving strategy there are a range of practical issues a client should be aware of:

Contribution reserves and reporting

It is important to note that where a client implements a contribution reserving strategy, the ATO has confirmed that regardless of TD 2013/22, a trustee must still report member contributions in the year they are received rather than the year they are allocated. As a result, in the above concessional contribution example, the member's fund would be required to report total personal contributions for the member in 2020-21 of $52,500 in the SMSF annual return.

However, to allow the ATO to properly administer the concessional cap, it has released a form (Request to adjust concessional contributions) which allows a member to notify the ATO that the trustee has allocated a concessional contribution made in one financial year in the subsequent financial year. The ATO then uses this information to adjust the contributions information reported in the SMSF's annual return.

However, the ATO has confirmed that it is only possible to use this form in relation to concessional contributions and not non-concessional contributions. Instead, the ATO has clarified that a member in the same situation but who made non-concessional contributions will need to write to the ATO outlining the situation and request their contributions be re-allocated to the following financial year.

Documentation required

To implement a contribution reserving strategy the ATO has confirmed that a trustee will need to keep records to substantiate what has occurred. These include:

- a resolution by trustees in the year the contribution is received in accordance with the SMSF's governing rules, not to allocate the contribution when it is made but to accept it into a reserve
- evidence of receipt of the contribution by the SMSF
- a resolution by trustees to allocate the contribution from the reserve in the following financial year in accordance with SIS Regulation 7.08(2).

It should also be noted that a trustee should not attempt to utilise a contribution reserving strategy to break up any individual contributions made in June and then allocate different amounts in June and July so as to avoid a member exceeding their cap and incurring an additional tax liability, as this may be considered tax avoidance.

Contribution reserving and total superannuation balance

Where a trustee implements a contribution reserving strategy, the member should be aware that the value of their unallocated contributions on 30 June will still generally count towards their Total Superannuation Balance (TSB) and could impact a range of issues, such as their non-concessional cap in the following year (see s307-205(2) of ITAA 1997).

For example, if the inclusion of a member's unallocated contributions on 30 June caused their TSB to exceed the general transfer balance cap, their non-concessional cap in the following year would be nil and the trustee would be unable to allocate any non-concessional contributions in that year without causing the member to exceed their non-concessional cap.

Craig Day is an Executive Manager and Head of Technical Services at Colonial First State. This article is for general information only and readers should seek professional advice on their personal circumstances before taking action.