Firstlinks
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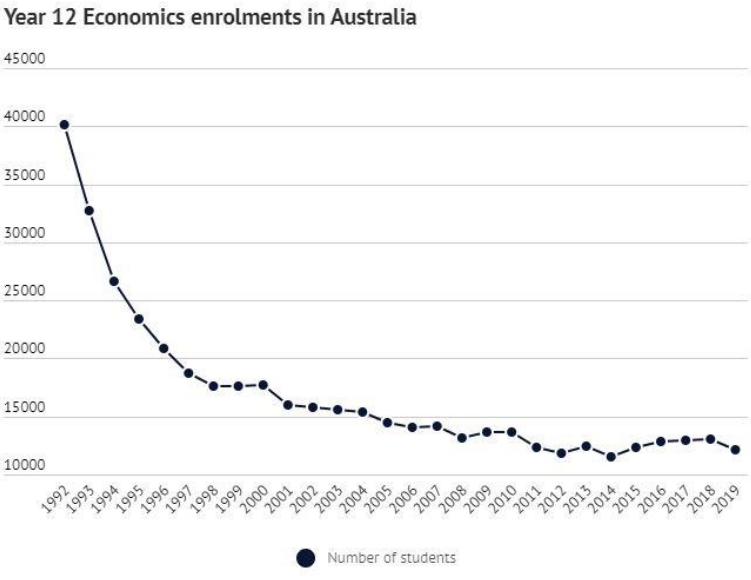
## Editorial

My undergraduate degree majored in economics, a popular subject in the 1970s. It was my favourite HSC study and in the Randwick Boys High School hall (yes, folks, we don't all go to private schools) is an economics honour board with my name on it. What's not to like? Well, apparently, a lot, because economics is less popular in schools than ever. In NSW, of the 76,000 HSC students in 2020, only 5,072 sat the economics exam. Many drop out in year 11 due to the heavy emphasis on mathematics.

There's an easy fix. Judging by the number of young people in the sharemarket for the first time in FY21, call the subject 'Investing and Economics', update the syllabus and enrolments would go through the roof.

The authors of the study of 4,800 students in years 10 to 12 (15- to 18-year-olds), **Tanya Livermore and Mike Major** of the **Reserve Bank**, report:

*"We find that high school students typically have positive perceptions of economics as a field; however, the perceptions of Economics as a subject tend to be negative ... students from a lower socio-economic background are more likely to believe that 'it is a risk to study Economics because I don't know what it's about'".*

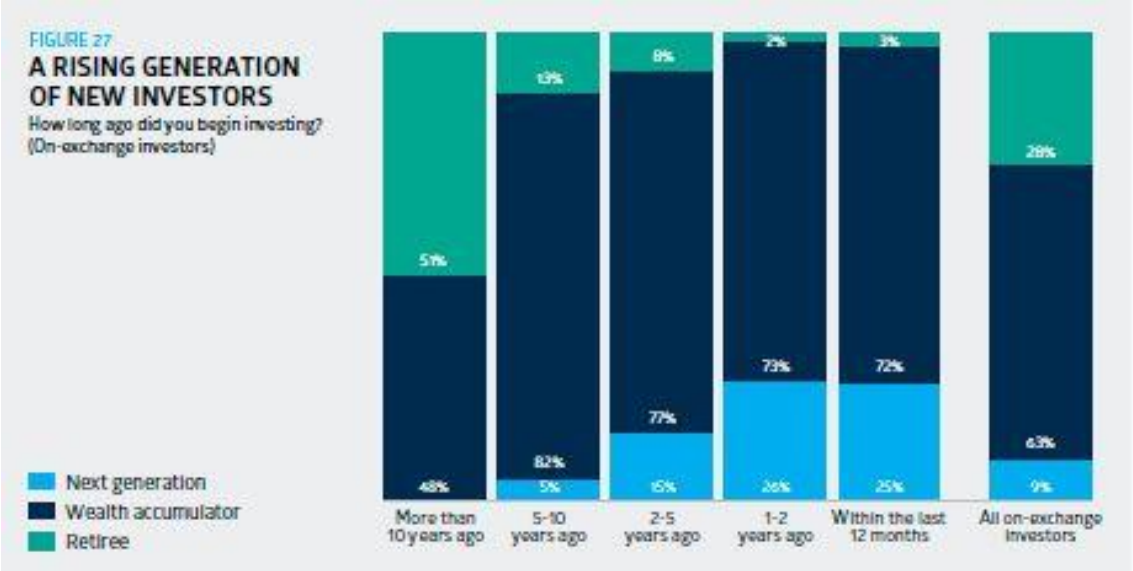



*Source: Reserve Bank*

Unfortunately, the students from lower socio-economic backgrounds who would probably most benefit from understanding economics don't know what it's about.

Some version of economics/finance/investing should be compulsory in schools, and it should be easy to make it interesting. One major trend from COVID-19 is the big increase in young people investing or trading on stock exchanges for the first time, which we have written about before. According to the ASX Australian Investor Study:

*"The last two years have seen an influx of younger investors into the market. Among those who began investing on a securities exchange within the last two years, a quarter are next generation investors. And this trend looks set to continue, with 27% of intending investors (those planning to begin investing within 12 months) also under 25."*




One concern is where these new investors find ideas. ASIC Senior Manager of Retail Complex Products and Investor Protection, **Somer Taylor**, recently admitted at the **MarketLit** conference that social media presents a "degree of risk" as a source of information and creates challenges for the regulator.

*"There's a fragmented nature when we're talking about social media and the internet, there's the scale of information that we have to monitor, there's ease of access to that information and the rapid churn rate – these are all factors that make it a complex environment for us."*

We know from the **GameStop** saga, the millions of new players on **Robinhood** and similar cheap trading apps in Australia, an NFT worth US$69 million, influencers such as **Elon Musk** driving up prices of joke cryptocurrencies like **Dogecoin** ... and on it goes ... that investors will jump on any fad. Robinhood recently informed the market that its Robinhood Snacks newsletter and podcast had 32 million subscribers, and it's a business based on options, leverage and selling its customers' orders to traders.

These new investors need reliable information or their investing will suffer, so let's rename the Economics subject, teach it in schools, add some investment content and bring everyone into the tent.

Each year, **Hugh Dive of Atlas Funds Management** looks at the worst performers of the previous year (in this case FY20) and checks how they went in the next year (FY21). Hugh says the average of the FY20 dogs rose 32.5% in FY21, ahead of the ASX200 Accumulation Index of 27.8%. Here are the dogs of FY21:

| Dogs of the ASX in FY21 | | | |
|---|---|---|---|
| Company | Industry | Return in 2021 | Reason for Large fall |
| The A2 Milk Company | Consumer Discretionary | -68% | Fall in sales to China |
| AGL Energy | Utilities | -47% | Falling wholesale electricity prices |
| AMP Limited | Financials | -35% | Ongoing malaise from Financial Services Inquiry |
| Northern Star | Gold | -25% | Stagnant gold prices and higher mining costs |
| Origin Energy | Energy | -19% | Falling power prices and unfavourable gas contracts |
| Orica Limited | Chemicals | -19% | Falling volumes of coal on Chinese import restrictions |
| Aurizon | Transport | -19% | Falling volumes of coal on Chinese import restrictions |
| Newcrest Mining | Gold | -18% | Stagnant gold prices and higher mining costs |
| Evolution Mining | Gold | -18% | Stagnant gold prices and higher mining costs |
| Beach Energy | Energy | -17% | Downgrade of gas reserves |

Hugh does not think much of their prospects in 2022:

*"Looking through the list of the underperformers of 2021, the key theme again is that the falls are from factors that are outside the company's control, such as Chinese import restrictions on Australian goods, falling electricity prices or the gold price ... the Chinese Communist Party gave little indication that investors can expect China to relax import restrictions on Australian goods in the near term. Similarly, it is difficult to see a significant increase in wholesale power prices for AGL Energy and Origin Energy in the face of government policies designed to drive down prices."*

And yet the dogs often beat the index in the next year.

As we head into a new financial year, this edition is packed with good ideas for young and old.

Starting at the retirement end, former leading consultant to super funds, **Don Ezra**, provides a fascinating article on how he approached his own retirement spending. He walks through three steps to decide how much he could safely spend each year and not run out of money.

After over 2,000 listens of our new podcast with **Peter Warnes** (Head of Equities Research at **Morningstar**), the next episode features the latest cash rate outlook, demographic change, debt serviceability and Peter's view on **Telstra**. Join our chat with a simple click.

Then **Andrew Macken** explains why the six leading tech companies of the world remain excellent investments, despite the US market pricing at all-time highs. They continue to change the ways we live and monetise their assets, and exposure to these companies has a role in every global portfolio.

We expect the **Your Future Your Super** to have a profound impact on super funds, some of it undeserved, and **Nick Callil and Tim Unger** show the high proportion of funds likely to fail the performance test over time. A new era of fund consolidation is upon us.

Continuing our series of four articles on modern retirement products, the second piece is **Emma Rapaport**'s check on **Magellan**'s new **FuturePay.** Magellan spent three years on the development to find a way to add support to its equity funds.

It was also notable that Magellan announced its intention to convert its High Conviction Trust (ASX: MHH) to an open-ended Active ETF from a closed-ended LIC. Another victory for the ETF structure. **Robin Bowerman** provides a primer on ETFs, LICs and managed funds to show the major features investors should know. Don't assume they are all the same.

The start of the FY is a good time to check the asset allocation of your portfolio as prices shifted over the year, and **Sophie Antal Gilbert** explains the importance of rebalancing. With sharemarkets rising, do you have more risk than you want?

**Michael Collins** writes on the switch to electric vehicles as he highlights some problems they face which are often overlooked. The move to this new power is inevitable but EVs face challenges.

And at this time of year, we remind our readers about the risks involved in the timing of investments in ETFs and unit trusts which must distribute earnings (income and capital gains) to investors. With some funds rebalancing and realising large capital gains, investors need to watch they are not incurring an unexpected tax bill.

Finally, as a counter to the criticisms LICs face, our **Comment of the Week** comes from **Danny**, in response to our article explaining when LICs have a role.

*"I love LIC's. ETF's are my larger holding but LIC's are my fix for individual shares. They still keep spitting dividends and have done really well for me for many years. When I say LIC's, for me, its the grand daddy's (AFI, MLT, ARG etc.)"*

## Three steps to planning your spending in retirement

Don Ezra

How to make your retirement savings last is an age-old conundrum. Bill Sharpe, the US economist and Nobel Prize winner, called it "*the hardest, nastiest problem in finance*". How much can you sustainably withdraw from your pension pot? And what's a sensible way to allocate assets in it?

The problem of 'decumulation', to use the industry jargon, is simple to state but not easy to tackle. How long will you live? You don't know. What return will you earn on the money? You don't know that either.

Baby Boomers, those born from the end of the Second World War to the mid-1960s, are retiring in their millions with no perfect answers to these questions. So in the absence of an optimal solution, how do you find one that works for you, based on well-founded principles?

**Break down the problem**

My wife and I had retirement savings and other assets but were not members of defined benefit pension schemes. In my career as an actuary and superannuation fund consultant, all I knew about were the principles underlying these schemes. So I decided to conduct a thought experiment: I would project a defined benefit scheme forward some decades and imagine that the two of us are the last surviving members.

The principles are straightforward.

Make a reasonable assumption about the average future lifespan of the members. That, along with the benefit formula, leads to an estimate of the annual cash flow promised to the members. Make some reasonable assumptions about the investment return of the fund. That tells you whether the amount in the fund, plus the future returns, will be sufficient. If it's insufficient, you need to add more money.

When there are only two of us left, and the withdrawals we'd like are too large to be supported by our super pot, nobody is going to contribute more money for us. Instead, we need to reduce our withdrawals.

There were three steps involved.

**First**, we assessed our combined longevity and its uncertainty.

**Second**, we needed to balance cash flow safety and investment growth, in other words, decide on our tolerance for taking investment risk.

**Third**, we needed to estimate the pace at which we can sustainably withdraw money to spend.

It's like driving on a long journey. We know where we are on the map, and we've made our own decisions on direction and speed. There'll be corrections as the map unfolds, but we feel we're in the driver's seat, and that's as much control as anyone can have.

**1. How long will you live?**

For a large scheme with many members, average life expectancy works fine as an estimate. For us, outliving the average was a big financial risk, with a 50/50 chance of this happening by definition. I thought we should reduce the risk and see what the numbers looked like when we used a longer time horizon, one that, not 50%, but only 25% of couples like us would outlive.

I used this longevity table by the American Academy of Actuaries and Society of Actuaries (Editor note: former financial adviser, David Williams, has an Australian version here).

What did that mean for us? When I reassessed our position after I turned 70, our 'joint and last survivor' life expectancy (the likely period until the second death) was 26 years, meaning that 50% of couples of our ages would live longer. The period that only 25% would outlive was 31 years, so that became our initial planning horizon.

We could have been even more cautious and chosen the horizon that only 10% of couples of our ages are likely to outlive. That would have been 36 years.

**2. How will you allocate between assets?**

The second step involved balancing cash flow safety and investment growth.

Take it as a given that we wanted growth so we focusses on investing our pot in a global equity index fund. Yes, there are alternatives, but this was simple, inexpensive and didn't require expertise. But wait. Putting 100% in growth assets from which we need to make periodic withdrawals exposes us to something called 'sequence of returns risk' (or sequencing risk).

Because we're always withdrawing money, our assets decline over time. So if we have poor returns early, there won't be enough of a base to make up the losses even if the later returns become above average. So we need to be able to make withdrawals without affecting the shortfall too much.

What do pension funds do when faced with this problem? They don't invest 100% of their assets to seek growth. They invest some assets in ways that automatically match a few years of cash flow, so they get that early cash flow without touching the growth assets.

How much is a matter of risk tolerance. For me, I'll feel OK withdrawing cash flow from the growth assets as long as they haven't lost purchasing power. In other words, I want a return of at least 0% after allowing for inflation.

That left me with a specific question to investigate. Over the past 50 years, what period of consecutive years was necessary after a decline until the market recovered, say, 75% of the time? (I chose 75% because that would give us the same chance of investment success as we sought with our longevity risk.)

The answer varies by country. Suppose you place six years of withdrawals in safe instruments and the rest in growth assets. If the market falls and you use your safe instruments for cash flow, historically 75% of the time your growth assets will have recovered before you need to make a withdrawal from them.

What if we wanted a 90% chance of growth assets recovering after a fall? In the US, we'd need 11 years of withdrawals in cash-like assets.

Historically, a portfolio with 90% growth assets and 10% government bonds needed 5-year holding periods for a positive real return 75% of the time, and only 6 years for a positive real return 90% of the time. Raise the level of bonds to 20%, and the portfolio needed the same 6 years for 90% positive real returns, but only 3-year holding periods for positive returns 75% of the time. We used 5 years.

This is encouraging, but bear in mind that the last three decades have been an exceptionally favourable period for bonds as interest rates fell. And remember, all my analysis is just history. I'm not expecting it to repeat itself. If it repeats itself in broad terms, well and good. If it doesn't – well, I don't expect it to, and I'll adjust.

**3. How much will you take?**

With our 25% risk exposure level, how much can we actually withdraw? And what if our risk tolerance is not 25% but 10%? Without these numbers, we don't know how much future spending is sustainable, and how we'll feel about it.

Remember that in the 25% risk situation, my wife and I would need to hold 5 years of cash flow in safe assets and the rest in growth. I used 0% as the future annual real return for these assets and 4% for the growth assets. (That's lower than history suggested, but I wanted a further margin of caution. Also, in these days of low interest rates, that hoped-for 0% annual real return on the safe assets isn't coming through.)

Every year we take a year's indicated withdrawal from the safe assets and replenish them by cashing in from the growth assets. The withdrawal (to be increased by inflation each year) must be calculated so as to last 31 years.

**Answer: for each $100,000 of our pension pot, the indicated annual sustainable withdrawal was $5,080.**

So the safety amount is five years of that, or $25,000 in round numbers. To my mind, this isn't an investment, it's our personal self-insurance bucket against a market decline. The remaining $75,000 goes into growth assets (perhaps diluted to 90/10 by government bonds). By traditional measures that's an astonishingly high percentage but it's based on long-standing pension principles.

Traditionally, exposure to growth assets in decumulation is suggested to be 100 minus your age. For a 70-year-old, this means 30% in growth. But that's a rule of thumb, and I'm defining caution much more clearly: not an arbitrary reduction in volatility but avoiding sequence-of-returns risk with a (historical) 75% chance of success.

What would the result be with the 10% risk posture, involving a 36-year horizon and 11 years of anticipated withdrawals in the self-insurance bucket? Answer: for each $100,000 of our pension pot, the annual sustainable withdrawal would be $3,930, so the self-insurance bucket holds 11 times this amount ($43,230) and the remaining roughly 57% goes into growth assets. That 57% is also dramatically higher than traditional practice suggests.

**This framework leads to our decision**

Now, with these numbers available, we could make our decision. We scaled the annual withdrawal numbers to reflect our total retirement savings pot (which includes all our financial assets, not just our tax-deferred assets). We went for the higher withdrawal level at a risk tolerance of 25%. We didn't consider anything in between 25% and 10%.

Here's a table showing how the indicated withdrawal per $100,000 pension pot changes with the length of the planning horizon and the number of years in your self-insurance bucket. Multiplying by your own pot and adding your other sources of income, you can see what's indicated for you.

**Estimated annual sustainable real withdrawal per $100,000 in retirement savings**

| | Planning horizon (years) | | | | | |
|---|---|---|---|---|---|---|
| Insurance bucket (years) | 10 | 15 | 20 | 25 | 30 | 35 |
| 2 | 11,520 | 8,490 | 7,070 | 6,290 | 5,850 | 5,610 |
| 3 | 11,170 | 8,180 | 6,770 | 6,000 | 5,550 | 5,350 |
| 4 | 10,890 | 7,920 | 6,530 | 5,770 | 5,330 | 5,110 |
| 5 | | 7,690 | 6,330 | 5,580 | 5,150 | 4,890 |
| 7 | | 7,310 | 5,960 | 5,220 | 4,790 | 4,530 |
| 10 | | | 5,560 | 4,810 | 4,360 | 4,090 |

*(Based on annual real returns of 0% in the safety bucket and 4% in the growth portfolio)*

**Theory and practice**

What happened when we put all this to work?

The global stock market index dropped about 8% in December 2018. We took no action and decided to see where we were in five years. When the global index fell 8% in February 2020 and a further 13% in March, our attitude was the same.

Of course, we were lucky that the market recovered quickly. It was much worse from September 2008 to February 2009, when the cumulative fall was 40%. But again we were lucky, because before the end of 2009 the markets had recovered that loss.

What if we're not lucky in the future? Then after five years the market won't have recovered, and we'll have exhausted our self-insurance bucket, and we'll be forced to cash out from the growth assets at some low level, with no further protection from market volatility.

If this happens, we could at least avoid a massive cut to our withdrawal amount by spreading that reduction over the remaining period to the end of the planning horizon. A really bad outcome means five successive years of gradual reductions, followed by complete exposure to market volatility.

There's another safety factor here. When one of us passes away, the 25% longevity estimate for the survivor will fall and the required spending to retain the lifestyle will also fall, since it only has to support one person. Our assessment doesn't take either adjustment into account in advance, so we have two further margins of safety.

Of course, there are risks. Market declines might be steeper and longer than history suggests. If that happens, the gradual declines in our withdrawals following a negative return won't be enough. We're conscious of that.

**More risk than traditional planning**

One takeaway from this exercise is that you can afford to take more investment risk with your portfolio than conventional thinking suggests. But perhaps the hardest is the ongoing discipline.

You need to gather the relevant information about your pension pot; have an idea of a desirable budget; use longevity tables; have access to something like the spreadsheet I mentioned; and make sensible assumptions about future investment returns.

Those are the set-up tasks; the ongoing disciplines are creating the self-insurance and growth portfolios, making the withdrawals and rebalancing periodically (which is much more tedious than making the withdrawals).

You may be wondering whether you want to sign up to this or will be able to maintain it throughout your retirement. Of course, if you want to proceed but lack confidence, you can ask a financial planner for advice.

*Don Ezra, now happily retired, is the former Co-Chairman of global consulting for Russell Investments worldwide, and the author of "Life Two: how to get to and enjoy what used to be called retirement". This article is general information and does not consider the circumstances of any investor.*

## Why mega-tech growth are the best 'value' stocks in the market

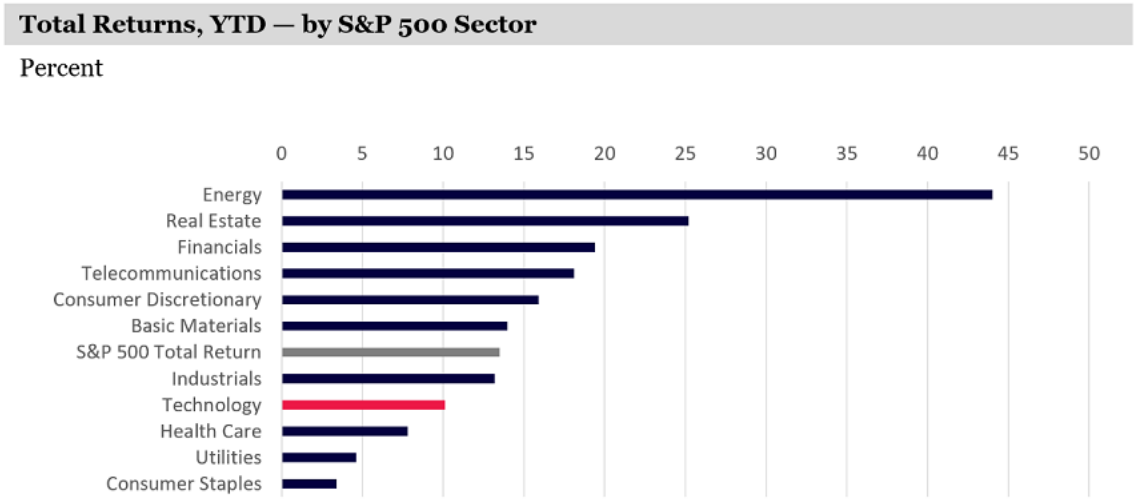
### Andrew Macken

The world's annual $120 trillion economy increasingly depends on just six mega-tech businesses – Facebook, Alphabet (Google), Microsoft, Amazon, Tencent and Alibaba – to function properly. You would think they would continue to all be obvious inclusions in portfolios but investors today have a menu of reasons to avoid or even sell mega-tech investments.

After a strong 2020, many investors are worried all the '*easy money has been made*' – a commonly used phrase we hear in our industry which also suffers from acute hindsight bias. Investors are also worried inflation will drive interest rates higher and compress the earnings multiples of higher-growth businesses.

Mega-tech investments also seem boring now – a surprisingly strong criterion some investors seek to avoid. And, of course, there are the never-ending headlines pointing to regulatory pressures across the sector.

**Tech has underperformed year-to-date**




*Source: Bloomberg (YTD returns as at 18 June 2021)*

Yet our analysis shows that mega-tech stocks not only offer some of the best growth opportunities, but also offer some of the best 'value' opportunities in the market today. We see material upside in all six of these mega technology businesses. Given the combination of strong and growing advantages, enormous growth opportunities, and material undervaluation today, we believe these names should form the core of any global equities portfolio.

Investors shouldn't rotate out of mega-tech to value because mega-tech are value.

Our investment philosophy is to own long-term winning businesses operating in the world's most attractive markets, without overpaying. These mega-tech businesses meet these criteria in the strongest way and they form the core of our portfolio.

Below we look at the top three reasons why mega-tech stocks are some of today's best value stocks.

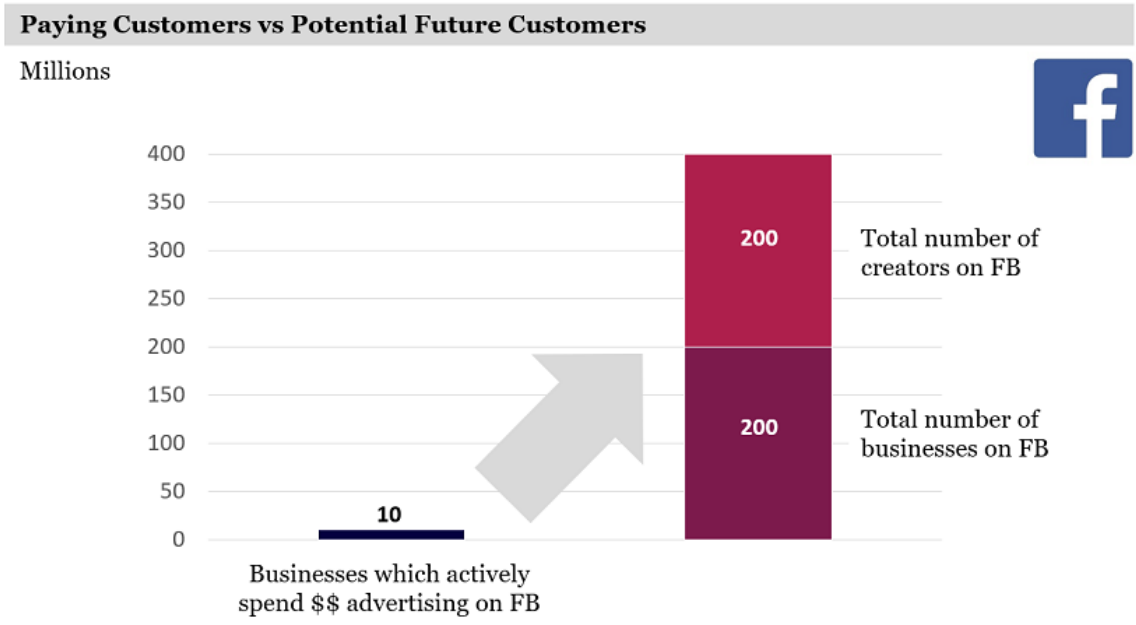
**1. Mega-techs have the best businesses … ever?**

The first reason is that the business quality of today's mega-techs is among the highest that humans have ever created. They dominate global data, benefit from enormous ecosystems, and have superior economics and scale. The huge cash flows and profits these businesses generate can be reinvested in new business opportunities, spurring fresh rounds of growth. These mega-techs all have a vast array of high-probability growth options in enormous new TAMs (total addressable markets).

Take Facebook, for example. More than 3 billion members log in and spend significant time each month on its platforms. It is unquestionably the world's best platform for marketers to reach customers. Facebook's revenues and earnings have been largely driven by the company monetising around 10 million businesses who pay for the company's digital marketing services. But approximately 200 million businesses use Facebook today, as well as another 200 million 'creators'.

Facebook is now investing heavily in its conversion and monetisation capabilities, particularly in eCommerce and creator monetisation tools. This will unlock the enormous latent revenue opportunity of these currently non-paying businesses and creators. It gives us great confidence that Facebook's future revenue and earnings power will be multiples of its current levels.

**Facebook: Only a tiny fraction of customers monetise today**




*Source: Facebook, Mark Zuckerberg*

Alphabet is also leveraging its advantages in data, talent and time to become a clear global leader in artificial intelligence (AI), which will not only strengthen its existing advantages in its core advertising, cloud and productivity businesses, but will also create brand new businesses, such as Verily which is leveraging Alphabet's data advantages to solve problems in life sciences and healthcare.

And, of course, one of the biggest areas of future mega-tech growth is the cloud. Amazon, Microsoft and Alphabet, along with Alibaba and Tencent in China, dominate the cloud. Microsoft CEO, Satya Nadella, estimates there will be approximately $8 trillion in incremental IT spend each year globally by 2030, of which cloud-based services and applications will no doubt claim the lion's share. For the leading cloud providers, their advantages in scale, data and customer captivity will only continue to strengthen over time. Said another way, this is a space for which enormous growth is largely assured and for which the winners have already been defined today. This means that the future revenues and earnings power of these businesses will also be multiples of their current levels.

**2. Inflation concerns are overdone**

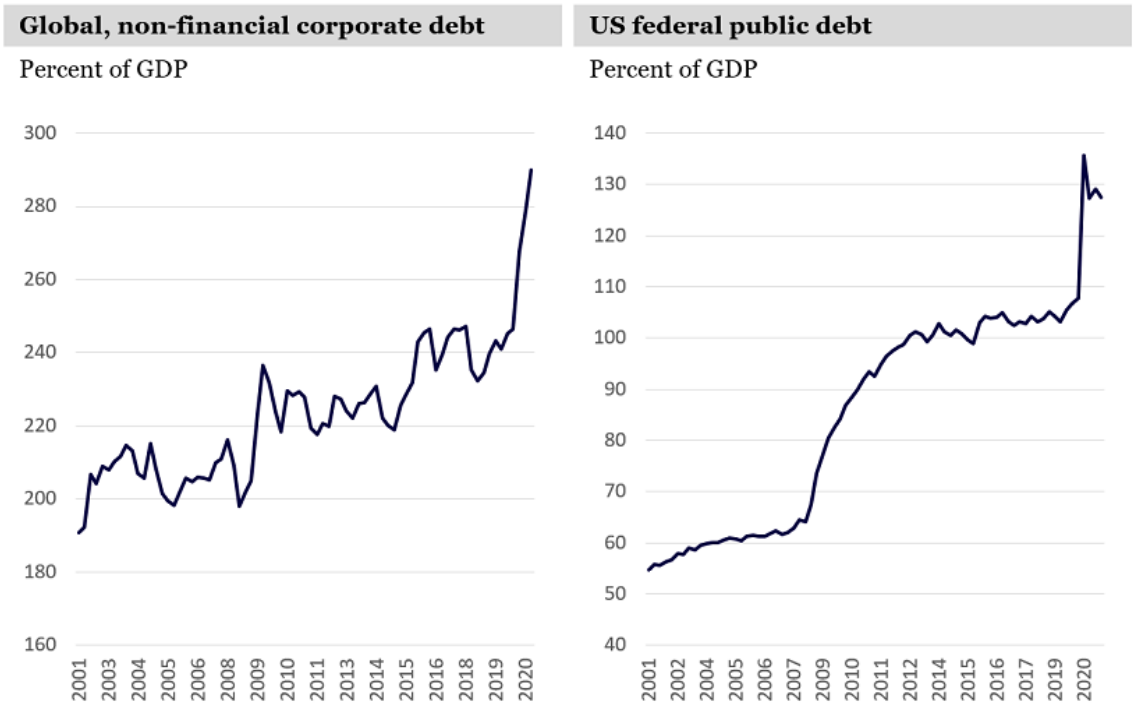
The second reason mega-tech provides fantastic value is that investors are too worried about inflation and what that could mean for interest rates and valuations. Over the first six months of this year, equities in the technology sector have underperformed the broader market largely because investors feared rising rates would slash tech valuations.

We believe those fears and the sell-off are overdone. While we note the same strong headline inflation numbers as everyone else, we struggle to see an extended acceleration in core inflation.

For a start, over the short-term, there remains significant slack in the labour markets relative to pre-pandemic levels, which should limit the acceleration in wage growth. Secondly, our analysis of Chinese credit growth shows a clear and substantial slowing, which is a strong leading indicator for cooling global commodities demand growth over the next 6-12 months.

We also expect structural disinflationary forces – such as ageing populations, labour-disrupting automation technologies and global corporate and government indebtedness – to persist for decades.

**Indebtedness: The upward trend has accelerated**




*Source: Bank of International Settlements, Federal Reserve Bank of St. Louis*

But something that has not yet been tested in any meaningful way is the pricing power of our mega-tech businesses. Should these businesses find it easy to increase their prices in an inflationary environment, then this goes some way to insulating investors from the negative effects of inflation. We believe the latent pricing power in these businesses is likely very strong – and in some cases, extraordinarily so.

Take Microsoft 365, for example – arguably one of the most mission-critical software packages upon which many hundreds of millions of employees are reliant each day. This costs just US$32/month, vastly below any reasonable estimate for the value it adds, strongly supporting our latent pricing power hypothesis.

**3. Current valuations are too conservative**

The final reason that mega-tech stocks are great value is their attractive valuations. Our analysis shows that the expectations baked into the current stock prices of our big-tech names are far too conservative.

- In the case of three dominant US cloud providers, **Amazon**, **Microsoft** and **Alphabet**, for example, their implied collective annual cloud revenues by 2030 are in the order of just $650 billion higher than current levels, according to consensus estimates. This is a tiny fraction of the $8 trillion increment that Microsoft CEO Nadella expects to accrue to the tech space over the next decade. If Nadella's forecast above is even remotely accurate, then these cloud providers will see much higher revenues (and earnings) in 2030 than what is currently being implied by consensus estimates.

- Next, consider **Tencent** and **Alibaba**, the latter of which has of course suffered greatly from the Jack Ma saga, with the billionaire Alibaba founder's fintech Ant Group IPO pulled at the last minute and with Ma reportedly under serious pressure from Chinese regulators and Government. In both cases, despite owning some of the most valuable data ecosystems in China and South-East Asia – including being the two

dominant cloud providers on the Mainland – their respective stock prices imply very conservative sets of expectations. Said another way, if revenue growth for these businesses were to fall from healthy-double-digits, to just single-digits by 2025, an investor today would still make money, based on Montaka's analysis.

- And finally, the biggest head-scratcher of them all is **Facebook**, which is priced at a forward earnings multiple of just 14x. Some of the businesses trading at a higher multiple than this today include Australia's Wesfarmers, Scentre Group, and plumbing parts supplier, Reece. At the current stock price, the market is effectively giving investors all of the upside from eCommerce, the monetisation of the creator economy, WhatsApp, Messenger and Reels, as well as Facebook's growth in VR/AR for free!

**Spectacular potential**

As the global economy grows, we are all becoming even more dependent on the highest-quality mega-tech winners.

Today, the collective revenues of these six businesses account for just 1% of global GDP. By 2030, global GDP will probably be around $160 trillion per annum, and these businesses will account for a much larger share than today.

For the patient investor who can look through the short-term noise, we believe these businesses are strong candidates to form the core of any global equities portfolio today. At Montaka, we will continue to own these businesses in size while their prices make sense. Patiently owning the winning businesses in the world's most attractive industries without overpaying is the way Montaka believes in safely compounding capital over the long term.

*Andrew Macken is Chief Investment Officer at Montaka Global Investments. This article is general information and is based on an understanding of current legislation.*

## Super performance test will destroy viability of some funds

### Nick Callil, Tim Unger

The Your Future, Your Super (YFYS) annual performance test will apply to MySuper products from 1 July 2021 and 'trustee directed' products from 1 July 2022. Some of its key features are:

- Product performance is tested against a benchmark comprising prescribed indices weighted in line with a fund's strategic asset allocation (SAA). This means that the test measures the effectiveness of a fund's implementation of its strategy relative to its YFYS benchmark, **not the suitability or performance of the strategy itself.**

- The performance measurement period is generally eight years (seven years for the first test). While a year of 'good' performance helps, each year is the start of a new performance period and so consistency of performance will be rewarded.

- A product passes the test provided the product return (including allowance for administration and advice fees) does not underperform the benchmark by more than 0.5% pa.

**A test with teeth and major consequences**

The result of failing the performance test is highly visible. Funds must send their members a notice (by paper mail, adding another expense) commencing with the words:

'***Your superannuation product has performed poorly. You should consider moving your money into a different fund***'

It's an unpalatable action for any fund. Two successive years of failure will see a product barred from accepting new members, which would damage cash flow and destroy the viability of most funds in a reputational sense.

So, this is most definitely a test with 'teeth'. All funds will weigh up the priority that should be given to meeting the performance test relative to other objectives. Some, perhaps most in the longer term, will change how their investment portfolios are designed and managed.

**The risk of underperformance**

As an indication of what might be in store, using APRA's December 2020 MySuper Product Heatmap, 11 single strategies, and a similar number of lifecycle strategies, were more than 0.5% p.a. behind the Listed SAA Benchmark over the six years to 31 December 2020. It's important to note however that the YFYS performance benchmark differs slightly from the Heatmap benchmark.

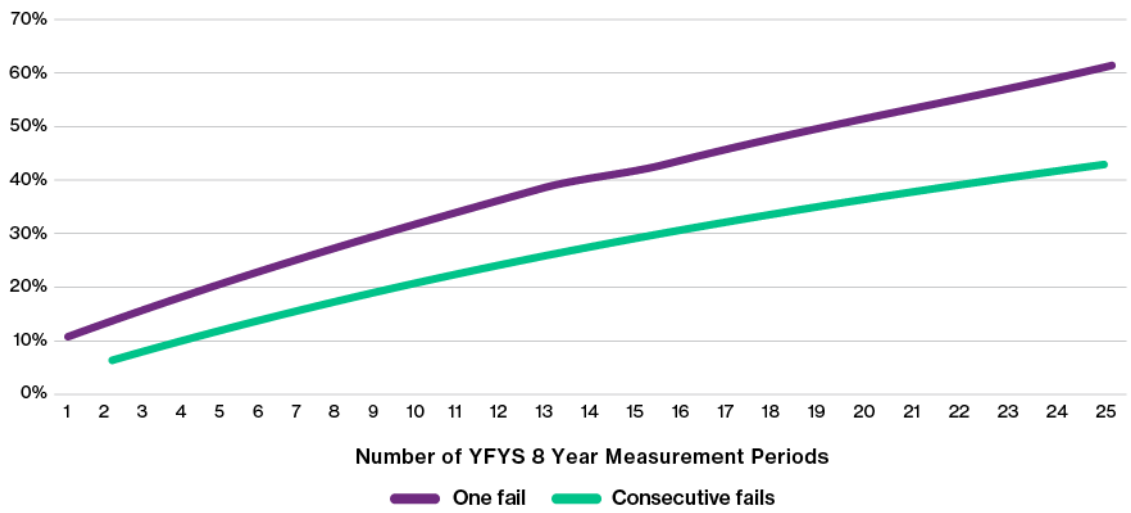
Looking forward, a year-by-year approach which blends past performance with forward-looking modelling will be required for products that have experienced underperformance in the past eight years.

Longer term, our analysis of a subset of MySuper options suggests a typical forward-looking probability of failing the performance test over a single eight-year period falls in the range of 10-15%. There is obviously some variability between products, with estimated tracking errors relative to the YFYS benchmark ranging from 2-4% per annum and probabilities of failing the performance test over a single eight-year period ranging from 6-16%.

While the likelihood of failing the test over a single eight-year period is a useful starting point, it doesn't accurately represent the prospect of the fund failing the performance test over a longer time period that incorporates a number of rolling eight-year time periods.

The chart below demonstrates the *cumulative* probability of failure over longer periods, assuming a 10% likelihood of failure over a single eight-year period.

**Cumulative probability of failing the performance test**




If we look at 10 consecutive performance measurement periods, covering a total of 17 years of fund performance (i.e. the first test covers years one to eight, while the 10th test covers years 10-17), the cumulative probability of underperformance reaches 35%. If we extend this to 20 measurement periods, then the cumulative probability of underperformance increases to over 50%.

Over the same period, the likelihood of failing the test in two consecutive years is also around 35%. The longer-term risks of falling foul of the test are clearly material.

**Implications for super funds**

We have already seen funds make portfolio and product changes, in anticipation of the test becoming law. Conceivably, we could see a bifurcation of strategies adopted.

Those with a strong brand name and market presence, or a well-defined and 'sticky' membership base, may consider a failure of the test (at least for one year) to be manageable and hence may be comfortable sticking with their existing investment approach and strategy.

Those with a weaker franchise might make passing the test their highest priority, dialling down the underperformance risk to an acceptably low level.

The broader implications of the YFYS package will play out over several years. It seems clear though that prioritising investment objectives, including determining how much emphasis to place on the YFYS performance test, will become a top tier issue for all funds.

*Nick Callil is the Head of Retirement Solutions and Tim Unger is Senior Investment Consultant at Willis Towers Watson Australia. This article is general information and based on a current understanding of the YFYS legislation.*

## Magellan's FuturePay seeks to offer income with added support

### Emma Rapaport

What if you could invest to grow your nest egg and take a regular, predictable income without having to sell down any of your capital? Sounds like the dream, right? Magellan's new FuturePay fund aims to do just that.

FuturePay (FPAY), issued by Australian fund manager Magellan, invests in a portfolio of high-quality, low volatility global listed companies which the manager believes can deliver attractive, risk-adjusted returns over the medium to long term. Portfolio constructions will be focused on protecting investors on the downside. Alongside returns and capital growth, the fund provides its investors with a predictable monthly income that grows with quarterly inflation.

Magellan will pay out returns from the global equity portfolio's regular income in good times and draw on the cash reserve (called a Support Trust) attached to the fund in the bad. At inception, the fund is targeting an initial yield of 4.3%, paid monthly.

Magellan Chief Executive Brett Cairns said the product sought to address the challenges faced by investors seeking to establish a reliable income stream in retirement.

"The challenge is thinking about the other side of accumulating savings," he said.

"Once you have some money, you then look to maintain access to those savings, and grow those savings such that you have a regular and predictable income that keeps pace with inflation.

"But it's also important that you don't erode your capital. This need shows up most in retirement where your savings need to replace your pay cheque. Here we wanted to re-establish some sense of a pay cheque that's regular and predictable, and into the future which is unknown.

Cairns added that he believed the investment needed "some sort of growth aspect" as a hedge to longevity risk and aid to intergenerational wealth transfer.

"Not knowing how long you're going to need that capital for means you're dipping into and eroding it over time. It leaves you with risk for how long you're going to live."

Cairns said that the idea for the fund, which was three years in the making, was drawn from a technique already used between advisers and their clients. This involves setting aside a "cash bucket", alongside the "growth bucket", to be drawn upon in down markets. As such, investors aren't forced to sell their investments when the markets fall but can dip into the cash. This, he says, is an acknowledgement that sequencing risk can work against retirees, but also that markets do recover over time.

**$50 million commitment**

Magellan Financial Group will initially seed the Support Trust with $50 million, paid in increments. The listed company has also committed a reserve facility equal to 2% of the fund, capped at $100 million to "provide additional support during poor market conditions".

Additional payments into the Support Trust will flow from two key sources:

1) When investors purchase units in the fund, a small amount of capital will be contributed from the fund to the trust. This is known as the 'adequacy contribution' and on the first day of trading stood at 6.71%. This ensures that investors coming into the fund pay for the value that's already in the trust and that the reserve remains adequate.

2) In rising markets, where the portfolio is outperforming its inflation-adjusted index, FuturePay may reserve a portion of its outperformance by contributing capital to the trust.

**Magellan FuturePay | Asset classes and allocation ranges**

| Asset Classes | Investment Range |
|---|---|
| Listed securities | 80% - 100% |
| Cash or cash equivalents | 0% - 20% |

*Source: FuturePay PDS*

The fund launch comes as Australian retirees seek to navigate a treacherous strait in the market. Today's rock-bottom interest rates have made drawing a regular, liveable income from a traditional 'retirement portfolio' with its higher allocation to bonds and cash near impossible. Meanwhile, retirees are generally reluctant to draw down their capital due to complexity, a lack of guidance, longevity risk and concerns about possible future health and aged care costs. This forces retirees to take on riskier investments in the search for yield at a time when they have less capacity to recover from market setbacks.

"Investing was once relatively straightforward for highly-conservative investors," Morningstar Editorial Director Graham Hand wrote in late 2019.

"As recently as 2012, the cash rate was greater than the 4% annual minimum drawdown required from a superannuation pension account. Further back to the 1990s, periods of double-digit cash and term deposit rates avoided the need to go into anything riskier than term deposits, although inflation was higher.

"Fast forward to now, as we enter the 2020s, there is nowhere to hide that gives capital security, a return greater than inflation and avoids a continual drawdown on a pension."

**Captive cash and equity market exposure**

So, what's the catch? The assets in the FuturePay Support Trust do not form part of the assets of the fund. Therefore, if you choose to redeem your units, the price you receive will reflect the value of the investment portfolio. You leave behind the value of your benefit in the reserve so that the remaining investors receive the benefit. Cairns says this reflects the 'mutualisation' of the fund.

"This fund is funded by the investors in FuturePay and it exists for the benefit of the investors in FuturePay – both by upfront contributions and ongoing contributions from outperformance," he says.

"Treating the reserves in this way leads to a material efficiency and while the initial reaction might be 'well, I'm leaving something behind', it does actually mean that you don't need as much in reserves."

The exit price from the fund will be the NAV per unit less the mutualisation amount. The NAV comprises the value of the securities the fund owns and the value of the Support Trust rights, but not its assets and liabilities. This structure could encourage investors to remain in the fund in falling markets, or when they need the cash, for fear of losing access to the cash distribution, which their initial investment and continued returns help fund.

The income investors receive, unlike a traditional life company annuity, is not guaranteed. It is a target. In deciding whether to make less frequent payments, the trustee may consider the fund's investment performance, the reserve ratio and prevailing market conditions.

The fee structure is complex. As stated, Magellan will charge a fee of up to 1% a year on the value of the investment portfolio. Fees are not charged for the value of the Support Trust or to Magellan to manage the support assets.

Magellan will also reduce its fee for interest it receives on cash held by the Support Trust. This is expected to result in the fee paid by investors on the total assets being managed by Magellan of around 0.90% per year.

Investors will also fund the reserve contributions made to the Support Trust, with an estimate of this net cost at 0.52% a year. Magellan says this cost will turn into a benefit when FuturePay receives payments from the reserves held by Support Trust.

In the end, this is still an equity fund with assets similar to Magellan's global and infrastructure funds. It's an equity fund that pays a regular, inflation-linked income, but an equity fund all the same. Equities carry risk to capital. Could you stomach a 50% equity market drop, and for how long? Magellan Global does have a long history of superior downside protection, most notably during the initial covid-19 sell-off, during which it fell 1.2% versus the index's 9% loss. But investors should, as the product disclosure statement recommends, expect to hold their investment in the fund for seven to ten years. There is no silver bullet, as Magellan General Manager Frank Casarotti noted.

"We do believe that this offer will be appealing to some investors, particularly in the retirement income space," he said at the launch.

Like its flagship Magellan Global product, FuturePay will have two access points – directly with the fund (via the unit registry) and via the Chi-X exchange, ticker FPAY. This will allow everyday investors immediate access and liquidity. Cairns also hopes the fund will appear across investment platforms, which could open the fund up to the advice market once it appears on approved product lists.

The first distribution has been set at 2.03 cents per unit, paid on the fifteenth of the month. The current income yield is around 4.25%, based on an initial NAV of $5.75 per unit.

*Emma Rapaport is Editor Manager at Morningstar, owner of Firstlinks. This article is general information and does not consider the circumstances of any investor. Magellan is a sponsor of Firstlinks.*

*This is the second of four articles which will examine alternative solutions to reduce the potential to run out of money for retirees. The first article is here.*

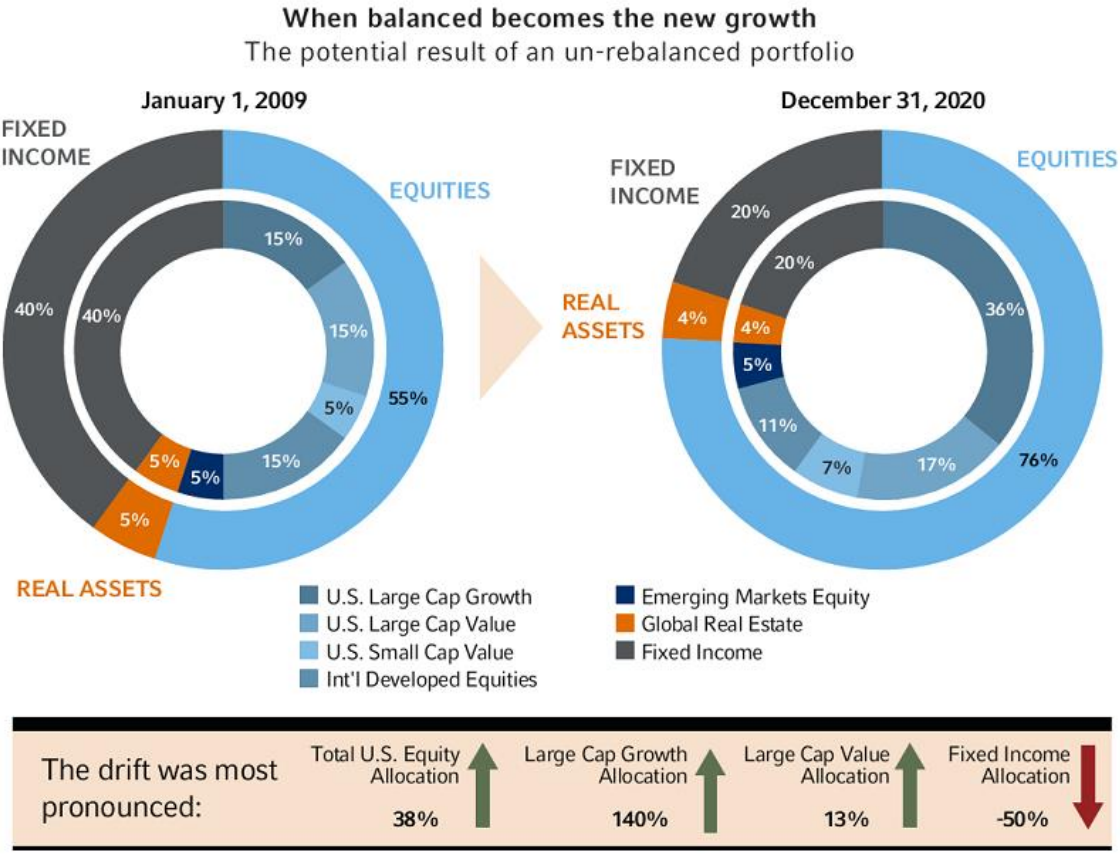
## Don't underestimate the value of active rebalancing

### Sophie Antal Gilbert

If there were ever a year in which the benefits of rebalancing were clear, 2020 was it.

We're still immersed in the middle of a market, economic and societal event like none of us have ever experienced. We've all been impacted, if not directly to our health, then by changes to the way we work, the way we connect to each other and certainly by the way we think about financial security.

When markets are rising calmly, it can be easy to underestimate the importance of disciplined rebalancing. But when markets gyrate wildly, as they did in March last year as the pandemic shuttered many aspects of the global economy, the value of active rebalancing can't be understated.



*Source: Hypothetical analysis provided in the chart & table above is for illustrative purposes only. Not intended to represent any actual investment. Source for both chart & table: U.S. Large Cap Growth: Russell 1000 Growth Index, U.S. Large Cap Value: Russell 1000 Value Index, U.S. Small Cap: Russell 2000® Index, International Developed Equities: MSCI World ex USA Index, Emerging Markets Equity: MSCI Emerging Markets Index; Global Real Estate: FTSE EPRA NAREIT Developed Index, and Fixed Income: Bloomberg Barclays U.S. Aggregate Bond Index.*

**Minimise the drift**

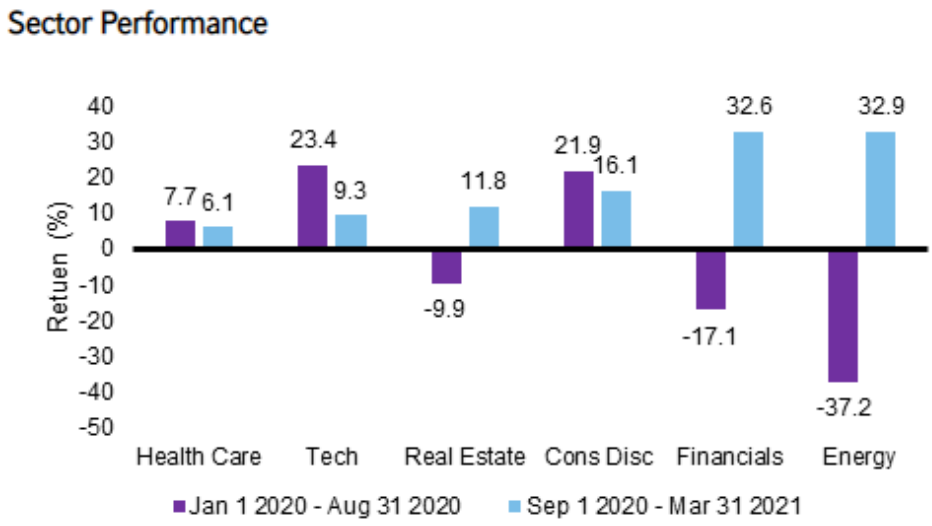
As the chart above demonstrates, a hypothetical balanced index portfolio that has not been rebalanced since the last major bout of market volatility during the GFC Crisis would have ended 2020 looking more like a growth portfolio, and would have exposed the investor to unintended risk.

Indeed, without rebalancing, by the end of December 2020, this hypothetical portfolio's exposure to U.S. large cap growth would have risen from 15% to 36% and the exposure to fixed income would have fallen from 40% to 20%. That's an unintended shift from a 60% equity/40% fixed income portfolio to an 80% equity/20% fixed income portfolio.

We all know the important role fixed income plays in smoothing out portfolio returns. More importantly, the portfolio would have a strong tilt to U.S. large cap growth and increasingly dominated by technology names. That tilt could be a concern if that sector were to suddenly reverse.

**Markets turn fast, is now the right time to rebalance?**

Last year, 2020, was a textbook example of how quickly markets can turn. The chart below shows just how dramatic the shift in sector performance was over the past year. For the first half of 2020, healthcare and technology stocks led the market. Within technology, those companies that benefited from the move to a virtual environment in 2020, such as Amazon, Alphabet (Google), Facebook, Microsoft and Apple, rose to represent 26% of the market cap of the S&P 500 Index in 2020. That's a level of market concentration we haven't seen in data we have going back 40 years! Since September 2020, traditional value-oriented sectors such as financials and energy have outperformed.




*Gross Total Return, net dividend withholding tax, in USD. MSCI indices. Source: MSCI and FactSet as of 31 March 2021.*

All of this speaks to the importance of regular rebalancing. Without it, it's likely that the increasing dominance of certain technology names could push asset allocations away from their policy targets to something with a greater tilt toward growth.

**A message to financial advisers: the value communication gap**

We consistently find there's a big gap between what investors *believe* advisors do and what advisors *actually* do. In other words, there's a value communication gap between advisors and their clients. Advisors don't always know what their clients *really* value. But what if you could tell your clients that by regularly rebalancing

their portfolio, you have maintained their asset allocation in line with their goals, helped smooth out returns and maintained their desired risk profile?

We believe that rebalancing is one of the most vital functions advisors provide. But the value of it is often downplayed. And when it comes to devaluing this vital service, advisors may be the main culprit. Why? Because it's something they do every single day.

*Unless you clearly communicate the value of rebalancing,* don't expect your clients to appreciate it. We believe that without the help of advisors, clients are more likely to make serious mistakes, such as buying high, selling low, or running to cash at precisely the wrong time. Indeed, many investors did flee the markets in March 2020, when the initial pandemic shock hit, and may have then missed out on the subsequent rebound.

We recommend four simple touchpoints to make the communication about rebalancing both easy for you and meaningful for your investor clients.

To help your clients understand the value of active rebalancing, make sure you let them know:

- The benefits of a systematic rebalancing policy
- What the strategic rebalancing policy is
- How frequently the portfolios are rebalanced
- Your approach to strategic rebalancing during periods of market volatility.

*Sophie Antal Gilbert is Head of Business Solutions at Russell Investments. To learn more about the 2021 Value of an Advisor Study, click here.*

## The switch is on as the EV revolution approaches

### Michael Collins

For Formula E motorsport, the 2020-21 racing season was transformational. Seven years after electric single-seaters first raced, Formula E gained the elevated 'championship' status enjoyed by Formula 1, World Endurance, World Rally and World Rallycross.

Then came the embarrassment, the 'absolute catastrophe', at the Valencia E-Prix in April. The Grande Finale turned shambolic when five appearances by the safety car forced an extra lap and the racers lacked the battery charge to compete at speed. Only nine of 24 qualifiers finished legitimately and three of these drivers crawled to the finish. Three other cars spluttered to a halt mid-last lap when they ran out of charge while five others were disqualified for exceeding energy limits to finish.

**The switch is on**

Don't be put off electric cars because an event to showcase the emissions-free driving option highlighted some of the challenges holding back the switch to green cars. In coming decades, electric vehicles are poised to become so reliable they will outsell those propelled by fossil fuels.

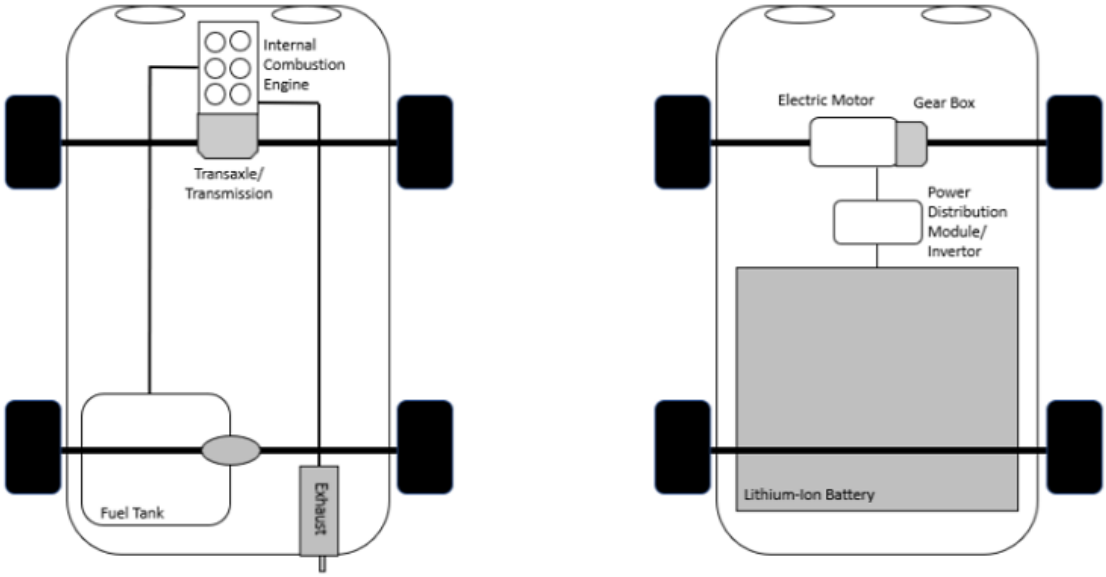
Fossil fuel vehicles account for about 10% of the global greenhouse-gas emissions driving climate change. Governments worldwide are promoting or mandating the switch. Automakers have pledged at least US$300 billion to go electric and compete with Tesla Motors, the leader of companies created to build electric.

The race is on to switch to cars whereby an electric motor, battery and single-gear gearbox replace an internal combustion engine, radiator, fuel tank and multi-geared transmission and clutch. Electric cars have only 20 moving parts compared with about 2,000 in fossil-fuel vehicles.

**But there are challenges to solve**

The switch to electric is hampered by the limits to battery power and thus distance. The infrastructure to ensure country-wide charging needs to be built. Another hurdle is that while electric vehicles are simpler to make because they have fewer parts, a battery that is the size of the back seat makes the cars more expensive to produce. The 60% higher price tag on average is slowing sales even though electric car owners save money on energy costs (up to 70%) and maintenance.

**Electric cars versus fossil-fuel vehicles**




*Source: UAW Research.*

Another challenge is that while green cars emit no local pollution their environmental benefits come with caveats. The first is that generating the electricity for recharging produces emissions, although emissions will fall over time as grids use more renewables. A second qualification is that batteries make electric vehicles more emissions-intensive to manufacture. The raw materials needed for battery cells, especially cobalt, lithium and rare earth elements, give off emissions during the smelting process. Thirdly, batteries are a challenge to recycle.

The switch to electric comes with some social costs. The typical electric car requires six times the mineral inputs of fossil-fuel counterparts by weight and securing triple the number of raw materials can be problematic. A notable social cost is that more than 60% of the world's cobalt supply comes from the Democratic Republic of Congo where children become ill and die mining for US$2 a day to attain the ore. Another possible side effect is that securing the supply of key battery ingredients located in far fewer countries than is oil might add to tensions between the West and China.

Electric cars right now are more a luxury purchase due to their higher price. But already 30% of global sales of mopeds, scooters and motorcycles are electric because the price differential over petrol equivalents is lower. Car sales will trend the same way if the price gap to fossil power is eliminated. Of the three touted future trends in driving – car sharing that makes ownership redundant, fully autonomous driving and electric vehicles – a world of green cars is the most believable.

**The role of alternatives**

To be sure, more advancements in the fuel economy of fossil fuels would reduce the case for electric vehicles. A halfway switch to hybrids might slow the switch to fully electric while unexpected leaps in hydrogen power could make electric cars passé. Governments might wind back green subsidies to repair their finances (especially as some will lose revenue from fuel excise). Any delay in battery improvements would slow the switch. Banning conventional cars might misfire if the masses can't afford electric.

While the pace of the switch is debatable, the world of electric cars is coming. Valencia E-Prix debacles aside, the breakthrough into mainstream should prove as seamless as the switch from manual to automatic.

*Michael Collins is an Investment Specialist at Magellan Asset Management, a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: https://www.magellangroup.com.au/insights/.*

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## Know your fund types and structures – an acronym odyssey

Robin Bowerman

Exchange-traded funds (ETFs) are enjoying their time in the spotlight when compared with their older counterparts, the unlisted managed funds (MFs) and listed investment companies (LICs). With the Australian ETF market surpassing $109 billion in assets under management (AUM) in May 2021, ETFs have moved into the mainstream with both investors and advisers.

While we don't see MFs and LICs dominating headlines as much, all three remain popular SMSF investment options that share some similarities but also some important differences that could make them more or less suitable for particular investors.

**1. Investment style and structure**

A key difference between LICs, ETFs and MFs is how they are structured and managed.

LICs are company structures governed by the Corporations Act and a board of directors. LICs are listed on the stock exchange via an IPO and shares are then issued to its subscribers. The capital raised by the IPO is then invested in a portfolio of securities chosen by the LIC's fund manager.

ETFs and MFs use a trust structure, where investors pool their capital with other investors. This combined capital is then invested on their behalf by a fund manager.

LICs are actively managed, whereas managed funds and ETFs offer both active and passive (index) styles. Investors must understand the underlying investment approach particularly if they are seeking an opportunity to outperform the market.

LICs are also close-ended funds, which means there's a set number of shares available to trade, determined by when the LIC is first listed or through any subsequent capital raisings. As such, new shares are not issued, or existing shares cancelled, when investors join or leave. Shares are bought and sold on-market so the total number of shares on issue does not change.

ETFs and MFs on the other hand are open-ended so the number of units on issue is not fixed. This means new shares can be created when investors buy the fund, or existing shares taken out of circulation if investors redeem funds, which overall contributes to strong liquidity.

This is a fundamental difference between LICs and ETFs.

Both trade daily on the ASX but because of the closed=ended structure of LICs, they will typically trade either at a discount (sometimes heavy) or at times, a premium. ETFs in contrast typically trade around their net asset value so investors pay the total of the prices of the securities within the portfolio.

Investors should be wary of LICs trading at discounts to the actual dollar value of their holdings. While it may seem like an opportunity to gain access to a portfolio of securities at less than their value, it may also mean investors could see losses if they intend to sell their LIC shares in the future and the discount has widened even further.

Some LICs have changed their structure recently from close-ended funds to ETFs or other open-ended funds in a bid to increase liquidity and address the issue of trading at persistent discounts.

**2. Access**

As their name suggests, LICs and ETFs can be bought and sold on the ASX through an online broker or trading account.

MFs however cannot be traded but instead, accessed directly through the fund provider or through financial advisers.

All three types of funds can provide SMSFs exposure to sectors, both domestic and international, that may otherwise be too costly or risky to access using direct investments.

**3. Diversification**

All three products provide strong diversification benefits to SMSFs as they offer access to hundreds or thousands of securities across, or within, a wide range of asset classes in just one investment vehicle.

Considering the generally low risk tolerance of many SMSFs, ETFs, MFs and LICs help mitigate portfolio risk because of their diversified nature.

**4. Income and tax**

ETFs, MFs and LICs can all provide a steady income stream dependent on the type of product selected (for example, high yield funds), but where they differ is how the distributions from these funds are paid out to investors.

Because LICs are incorporated companies, they pay a company tax of 30%. Distribution of dividends to shareholders is determined by the directors. This means LICs can also retain profits if they've generated particularly strong returns and steadily pay them out over future years.

This approach may be particularly beneficial to SMSFs which are looking for a smoother income stream, particularly during periods of heightened market volatility. Additionally, the income distributed by LICs can be franked which can subsequently reduce a SMSF's tax liability depending on the applicable rate.

ETFs and MFs pool together the dividends they receive from their underlying assets and then periodically pay them to investors in the form of distributions (typically quarterly or semi-annually). Unlike LICs, ETFs and MFs do not have the ability to decide how much of the distribution (including capital gains) to pay out. They must pay in full on the stated distribution dates. This means market movements can have an impact on both the size and nature of the distribution that ETF and MF investors receive.

For example, during the first half of calendar 2020, many companies reduced dividend payments reflecting reduced profits and greater economic uncertainty. This in turn lead to many funds and ETFs paying lower distributions in the financial year ended June 2020.

But in recent months, most equity markets have recovered to pre-pandemic levels, with some even reaching all-time highs. This might mean distributions from ETFs and MFs tracking the underlying performance of these equity indexes may notably increase.

Both situations can affect the income stream and tax position of SMSFs, and it's best for trustees to consult a licensed financial adviser if they are unsure of the impact.

**5. Pricing and costs**

Passive managed funds and ETFs tend to be lower cost than LICs because they are not actively managed. For example, SMSFs can invest in a broad Australian-market ETF for a management cost of just 0.1%, while many LICs covering narrower segments are charging 10 times that (1%) or more. Some LICs may also charge additional fees if they outperform their target market benchmark.

Some actively managed ETFs may have fees similar to actively-managed LICs and MFs.

Being mindful of how costs will add up over time is a key determinant of long-term investment success. With actively managed funds on average underperforming over the past three decades when compared to index funds, SMSFs should carefully assess if the extra fees paid to LICs are worth it.

**So which one is right for you? Strategy before structure**

Ultimately, selecting between ETFs, managed funds and listed investment companies should be determined by the SMSF trustee's goals, timeframe and risk tolerance.

*Robin Bowerman is a Principal and Head of Corporate Affairs at Vanguard Australia, a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.*

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## Warning about timing of investments in ETFs and trusts

Graham Hand

(This article republishes a previous warning at the end of the financial year about timing of distributions).

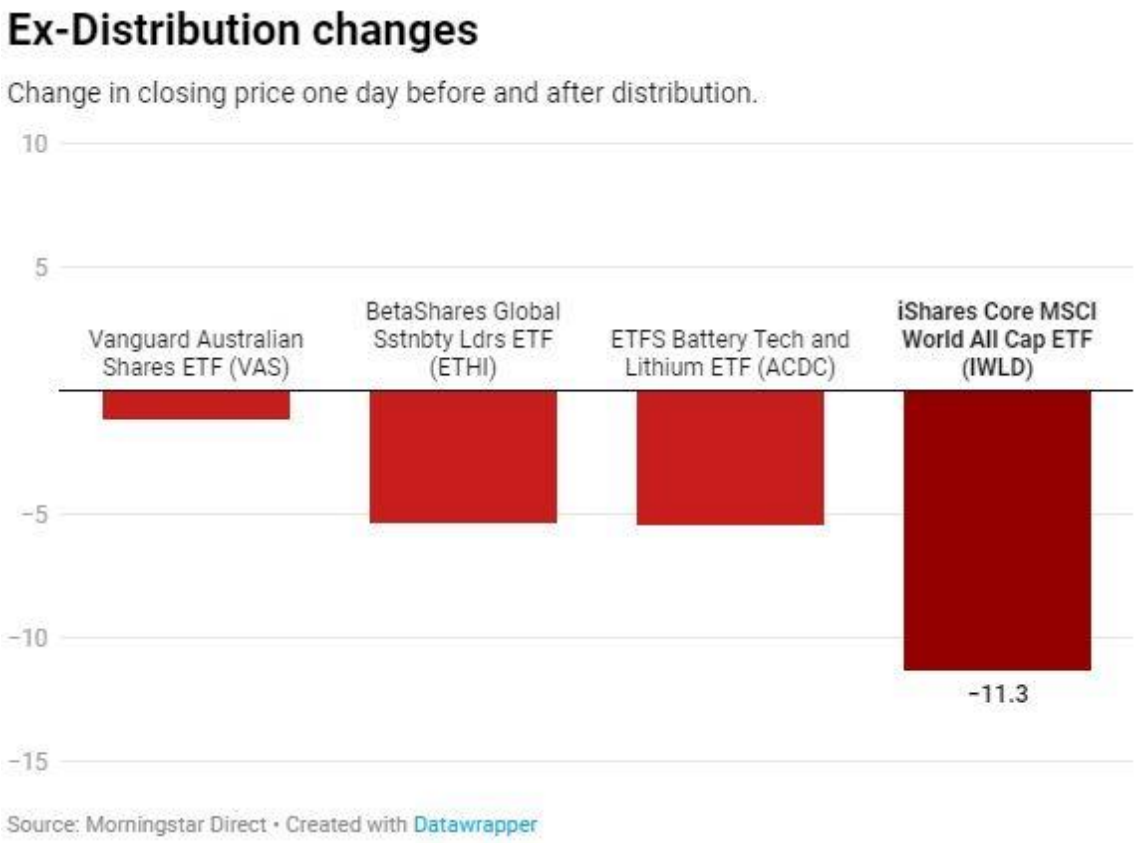
Most fund managers struggle to deliver a 1% outperformance after fees, and with the cash rate at 0.1%, investors need to eke out every bit of return they can find. So it's important to know how investment structures work. In particular, the tax impact of investing after a distribution can be a trap for the unwary and cause unexpected leakage in tax.

**Distributions from a unit trust**

In a unit trust, all income received (including realised capital gains) is divided among unit holders based on how many units they hold at the time of a distribution. Unit holders must then include their share of this income (which may comprise dividends, interest, capital gains and franking (imputation) credits) in their own tax return in the year it was earned.

The same distributions are paid to all unit holders according to their holding on a particular day, whether or not the investor was in the fund one day or one year. Distributions are not pro-rated for investors who were not unitholders for the whole period. An investor may receive some of their investment back immediately as income if they invested just before a distribution.

Immediately after a distribution is declared, the unit price of the fund will usually fall by the amount of the distribution, because the distribution reduces the fund's assets. For example, these ETFs listed on the Australian exchanges fell heavily after their FY21 distributions.




**Don't convert capital to taxable income**

An investment in June that receives a distribution in July may be converting capital to taxable income. For example, if someone invests on 25 June when the unit price is say $1.00 and then a 10 cent per unit distribution is made on 30 June, the unit price will fall to 90 cents (assuming no market movement) at the beginning of July. The 10 cents will be taxable income in the hands of the unit holder in their tax return.

Obviously, the worst consequences are for individuals with high marginal tax rates where the distribution includes no franking credits. This might be the case for a global equity fund which distributes once a year with no franking credits from Australian companies.

Alternatively, an investor such as a tax-free charity or super fund in pension mode in an Australian equity fund might pay no tax and receive a franking credit, so a June investment might actually be favourable for them.

The only way to eliminate these effects would be for the fund trustee to make a daily distribution, but clearly this is not practical. The more often a fund distributes income during the year then the less of an issue this distribution inequity becomes. For example, most Australian equity funds distribute twice per year but most international funds only distribute once per year.

Other funds with particularly punitive outcomes for unit holders who invest close to a distribution date might be actively traded funds in a rising market. They might have large capital gains on shares not held for longer than 12 months (and therefore, not subject to the 50% CGT discount factor). The distribution might contain a large taxable capital gain component.

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