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## Editorial

When my children were in primary school, a favourite activity on fund-raising evenings was the 'head and tails' game. Parents would pay to play and guess whether a coin toss would land on heads (place hands on head) or tails (hands on bottom or tail). After each round, the winners stay for another spin and so on until only one person remains.

Each time a round was played, a strange thing happened. Those who win cheer loudly and laugh at the losers. As the rounds pass by, the winners become louder and more enthusiastic, and the crowd applauds like it is witnessing a sporting event. It's all good fun of course, but eventually, the winner of a bottle of wine waves his or her hands in the air in triumph and friends shake the hand of the expert at picking coin tosses.

A similar event is described in the legendary book first published in 1940 called "*Where are the Customers' Yachts?*" or "*A Good Hard Look at Wall Street*" by **Fred Schwed Jr.** At the 2016 **Berkshire Hathaway** meeting, **Warren Buffett** claimed he read the book when he was 10-years-old and it was foundational in his investing. This is a long extract but worth reading.

> *"Let us have 400,000 men and women engage in this contest at one time. (Something like the number in this country who try being speculators.) We line them up, facing each other in pairs, across a refectory table miles long.*
>
> *Each player is going to play the person facing him a series of games, the game chosen being a matter of pure luck, say matching coins. Two hundred thousand on one side of the table face 200,000 on the other side. If the reader is at all mathematically inclined he should cease reading and work out for himself what is now bound to occur.*
>
> *Otherwise: The referee gives a signal for the first game and 400,000 coins flash in the sun as they are tossed. The scorers make their tabulations, and discover that 200,000 people are winners and 200,000 are losers. Then the second game is played. Of the original 200,000 winners, about half of them win again. We now have about 100,000 who have won two games and an equal number who have been so unfortunate as to lose both games. The rest have so far broken even.*
>
> *The simplest thing from now on is to keep our eyes on the winners. (No one is ever much interested in the losers, anyway) The third game is played, and of the 100,000 who have won both games half of them are again successful. These 50,000, in the fourth game, are reduced to 25,000, and in the fifth to 12,500. These 12,500 have won five straight without a loss and are no doubt beginning to fancy themselves as coin flippers.* ***They feel they have an 'instinct' for it****.*

*However, in the sixth game, 6,250 play on and are successively reduced in number until less than a thousand are left. This little band has won some nine straight without a loss, and by this time most of them have at least a local reputation for their ability.* ***People come from some distance to consult them about their method of calling heads and tails, and they modestly give explanations of how they have achieved their success.***

*Eventually there are about a dozen men or women who have won every single time for about 15 games. These are regarded as* ***the experts, the greatest coin flippers in history****, the people who never lose, and they have their biographies written." (my bolding)*

Fred does not go on to say funds management is the same, but there are a lot of coin tossers out there. How do we know that a fund manager experiencing a strong run of outperformance is not simply a winning coin flipper? We don't. The main challenge when hearing fund manager presentations is not to think that just because they are a confident and entertaining orator, they are also a skilled investor. Many are the opposite.

Look beyond the charisma and charm for unique insights and ideas which might reveal a deeper thinker who identifies different opportunities. There's no point hearing the same platitudes as every other fund manager and expecting to outperform. There are talented fund managers but it's hard to identify them in advance, and that's all that matters.

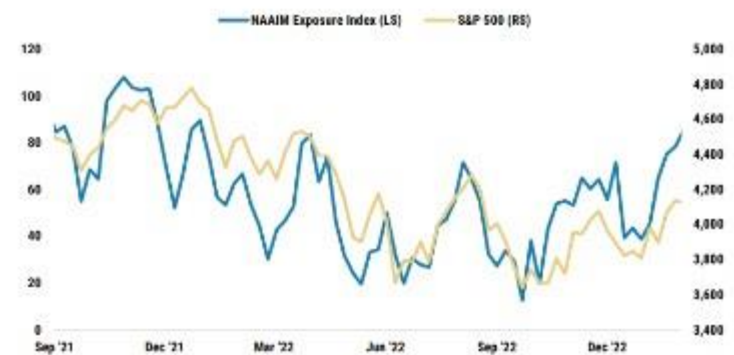
***

The most consistently-sobering assessment of the market's potential in 2023 comes from **Morgan Stanley** in the US, which has criticised the equity rally since it began in 2023. This week, the investment bank argued:

*"Price action is not reflective of the deteriorating fundamentals or the fact that the Fed is hiking during an earnings recession - drivers that should ultimately determine the lows for this bear market later this [US] spring. Risk-reward is as poor as it's been in our view."*

They are at odds with many active fund managers, who are "*refusing to accept this reality*" of higher rates and lower earnings. In fact, the **National Association of Active Investment Managers** (NAAIM) publishes an index each week which measures the average exposure to US equity markets by its members, and this has been increasing rapidly since the end of 2022. Looks like we are in for another year where the results of active managers will vary widely.

**Exhibit 3:** Active Managers Have Increased Equity Exposure




Source: NAAIM, Bloomberg, Morgan Stanley Research.

**Philip Lowe** probably has the highest exposure of any Reserve Bank Governor in history this week, so we don't need to repeat coverage of his travails. However, his presentation to the Senate on Wednesday included an interesting reveal. He repeatedly said that decisions are not his but those of the nine members of the Board and their views were unanimous: "*We all come to the same conclusions.*" This is remarkable given that the Governor has apologised for mistakes made in 2021, and yet nine experienced Board members agreed unanimously on interest rate decisions through three years of monthly loosening and tightening. Did nobody believe a small uptick in rates at the end of 2021 or early 2022 was worthwhile to take the steam out of the housing market and start the work against inflation? Lowe also complained that whoever spoke to the media after his lunchtime discussions at Barrenjoey broke the protocols on how to behave after these events.

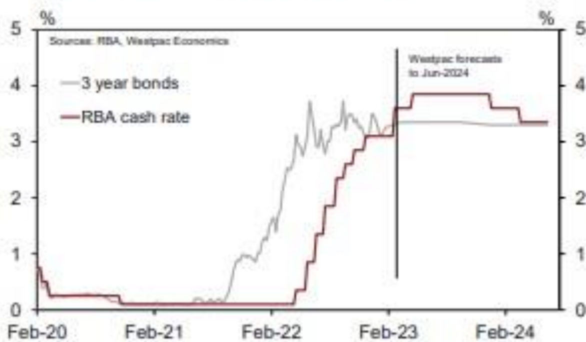
While sympathy rightly goes to heavily-indebted borrowers who will face a tough year, the other side of the same coin is that retiree incomes are rising, at least in nominal terms. A comment received from a reader, James, last week is typical of how many feel.

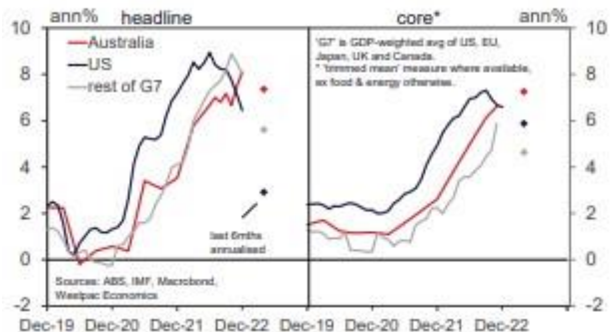
*"Stop the focus on home borrowers  - it's great for the retirees!!!! At long last retirees don't have to take crazy risk in mkts to get a return they can live on - who is going to print the truth!"*

That's the agony of using such a blunt tool as the cash rate to slow the economy. It targets one group of people but others are gaining a major income boost, which will stimulate the economy if they spend it, accepting that retirees tend to consume less than younger people.

Here are a couple of charts from Australian banks which suggest borrowers need to tough it out for 2023 before some relief next year. First, from ANZ-Roy Morgan, consumer confidence is falling rapidly, which should feed into lower consumption. The sub-index of '*Is it a good time to buy a major household item*' dropped to its lowest level in two years, especially among mortgage holders.

Second, the latest Westpac forecasts see a cash rate of 3.85% by the end of 2023 but falling back to 3.35% quickly in 2024. Westpac is also confident we have seen the peak of US inflation, as supply-side constraints ease for fuel, food, energy, goods, and building costs.




And note that the ATO has confirmed the Transfer Balance Cap (TBC) for superannuation will increase by $200,000 on 1 July 2023, reminding us:

*"No single TBC will apply to all individuals. Individuals will have a personal TBC between $1.6 and $1.9 million. If an individual already has a TBC, the only place they can view their personal TBC is in ATO online services through myGov."*

Which continues our irrational approach to setting superannuation limits. At the same time that we are encouraging more into super by raising the TBC, Financial Services Minister **Stephen Jones** has decided to cap superannuation balances at $5 million, probably from 1 July 2024. By then, a couple will be welcome to hold $4.2 million in super (based on a new indexed limit of $2.1 million each) but an individual cannot hold more than $5 million. All these rules with minor differences are adding even more complexity to the superannuation system, after governments have encouraged people to pour money in for the last 30 years. My article this week takes a critical look at the $5 million cap plan.

**Graham Hand**

**Also this week ...**

**Jon Kalkman** explores whether it makes sense to invest in the family home to maximise the pension. He thinks it may not be the best option as it can put retirees at the mercy of bureaucrats and comes at a high price in terms of reduced income and loss of discretion over personal affairs.

**Noel Whittaker** is cranky this week. He's upset at banks that charge increased interest rates on those who fall behind on home loan payments. Noel believes it's a widespread policy that kicks people when they're down and it needs to stop.

On the TBC increase to $1.9 million from 1 July 2023, only those who don't start pensions until then will receive the full increase. Many retirees are wondering if they should wait to start pensions in their SMSFs, and **Meg Heffron** has some answers. Still on super, **Dr David Knox** at Mercer believes superannuation taxes in Australia need an overhaul. David says the current system is complex, inequitable and subject to regular change. He proposes five ways to make the system fairer.

**James Gruber** says interest rates are political dynamite in Australia but increased rates aren't bad for everyone and they are exactly what's needed after the serious central banking errors of the past decade.

The common perception of contrarian investing is that it's about doing the opposite of everyone else but **Eric Marais** says that's not the case. Instead, it's having courage in your convictions and a disciplined investment process. Eric provides three stock examples to demonstrate Orbis Investment's unique approach.

In this week's white paper, **Montaka Global Investments** looks at why AI is the world's most important investment theme.

**Curated by James Gruber and Leisa Bell**

## $5 million cap punishes 30 years of super saving

### Graham Hand

Anyone hoping superannuation regulations will remain unchanged again in the next Federal Budget on 9 May 2023 is likely to be disappointed. Super was untouched in 2022 but the Financial Services Minister, Stephen Jones, has done enough jawboning to indicate he is ready to target high balances in super. This is despite the superannuation system introduced by his party 30 years ago in 1992 encouraging savers to use the wonders of compounding to build such large amounts.

Most large superannuation institutions have rolled over and even the industry lobby group, the Association of Superannuation Funds of Australia (ASFA), supports a cap. In its submission to the October 2022 Budget, ASFA said:

> *"A balance of $5 million in concessionally taxed superannuation cannot reasonably be justified as necessary to support a comfortable lifestyle in retirement. ASFA estimates that introducing a $5 million cap on the amount that an individual could hold in superannuation would lead to additional revenue of around $1.5 billion a year, although the exact amount raised would depend on how excess balances were invested after they were withdrawn from the superannuation system."*

Likewise, the Australian Institute of Superannuation Trustees (AIST) supports the cap and nominates a date, 1 July 2024, when the amount in excess of $5 million should be withdrawn from super.

It's not often a new limit on super members is waved through so readily. It's either that the industry and retail funds know they are substantially unaffected at $5 million, or it's better to promote a high cap than resist a smaller cap. It adds further complexity and another regulation to a retirement system that already confuses most Australians.

**Super is only for retirement income, not bequests**

The Government needs some political wins to rein in the budget deficit and the 11,000 Australians with more than $5 million in super are an easy target. That oft-quoted number comes from 2018 and it's probably closer to 20,000 or 30,000 now. The Retirement Income Review claimed a person with $5 million in super receives annual tax concessions worth about $70,000 because balances over $1.7 million are taxed at only 15%.

Minister Jones believes the first step is to define the purpose of superannuation, which has languished since the days of the 2014 Financial Systems Inquiry (FSI). In October 2015, Treasury announced:

> *"The Government has accepted the recommendation of the FSI that the objective of the superannuation system is to provide income in retirement to substitute or supplement the age pension."*

Once a purpose or objective is in place, Jones has the framework he needs to set a cap, with statements such as:

> *"I've got to say $5 million is a lot closer to the purpose of superannuation than $100 million ... If people have got superannuation balances in excess of $100 million, or even $50 million, I think it's pretty hard to argue that that's about retirement income ... It might be about estate management, it might be about tax management, but it's not about retirement income, and that really is not the purpose of superannuation."*

Confirming his view on 3 February 2023 on ABC Radio Breakfast, Jones said the consultation paper on the objective would be issued "*very, very soon*". I have previously written on different objective here, arguing that superannuation policy always considered its role as part of an estate.

The growing momentum is supported by think tanks such as the Australia Institute, who upped the ante by producing a paper called 'Self-funded or state-funded retirees? The cost of super tax concessions' claiming super tax concessions will cost the budget about $53 billion in the 2022–23 year which is marginally more than the age pension cost and an increase from 1.5% of GDP to over 2% in 20 years.

Other arguments for a lower cap include David Knox of Mercer (also featured in this edition of Firstlinks) who favours a limit of double the current $1.7 million transfer balance cap, although that is set to rise to $1.9 billion on 1 July 2023 due to CPI linking, which would take the proposed cap to $3.8 million. The Grattan Institute says lowering the cap to $2 million per person would raise almost $3 billion annually.

**Five reasons against introducing a $5 million cap**

To put the $5 million in perspective, let's consider what is possible based on other superannuation rules. By 1 July 2024, both the Transfer Balance Cap and the Total Superannuation Balance will probably reach $2.1 million per person due to indexation. Over 70% of people enter retirement in a couple and it's legitimate to focus on household assets rather than individuals. A married couple will have access to $4.2 million in a tax-free super pension by 1 July 2024.

Why are we introducing a new $5 million cap at the same time that other limits are rising close to the same level? It's more complexity in the super system. A one-person household with $5 million and $1.6 million in pension will pay far more tax than a household couple with $4.2 million tax-free.

As opposition to introducing the cap withers, let's look at the case for no change. And yes, I admit that I have a dog in this race.

**1. That's how long-term compounding works**

When Chris Jordan, the Commissioner of Taxation, was asked at a conference how members had accumulated such large amounts in their SMSFs, he said balances were usually accumulated for over 30 years or funds held one or two investments that had done extremely well. He called the large SMSFs "*accidents of history*" and he added, "*Don't design the system for the last worst person."*

You don't need to be Einstein (who never actually said compound interest is the Eighth Wonder of the World, but let's go with it) to use a calculator and work out the dramatic impact of compounding. Anyone with a good income and spare savings who decides to invest in equities in super for decades will accumulate large amounts of money. That's the power of compounding.

Sure, $5 million is a lot of money but it does not take vast wealth to accumulate such an amount with consistent investment over long periods. Consider how many working-class people now own $3 million homes in the western suburbs of Sydney by committing to a long-term savings pattern over 30 years called – wait for it ... it's a devious scheme that should be capped – 'paying off your home'. And many also qualify for the age pension.

Consider these examples:

| Initial deposit | Annual deposits | Number of years | Annual return (% pa) | Current balance |
|---|---|---|---|---|
| $50,000 | $50,000 | 30 | 8% pa | $6.2 million |
| $50,000 | $100,000 | 30 | 5% pa | $6.9 million |
| $50,000 | $50,000 | 25 | 10% pa | $5.5 million |

This is consistent saving over time. Successive governments of both colours not only allowed but encouraged significantly higher amounts than these to go into superannuation.

**2. Retrospective changes hit those who saved in super not homes**

Australians are living longer and many will spend 40 years in retirement. The days of work until 60 and drop dead at 70 are long gone. Since the introduction of compulsory super in 1992, Australians have been encouraged by the superannuation system and governments of the day to forego current day consumption to save for retirement. The system has legitimately allowed annual contributions (concessional and non-concessional) over 30 years plus one-off injections of up to $1 million.

The most obvious personal investment alternative over years is to upsize the family home. In my own case, I lived in the same house from 1989 to 2020, or 32 years. Instead of trading up to a more expensive home, savings went into superannuation. Is Stephen Jones telling me I should have bought the fancier house capital gains tax-free and now worth the GDP of a small Pacific nation?

So why is the person who decided to forego the extravagant home, Ferrari and lifestyle spending for 30 years and invest in a government-sponsored retirement system now forced to take out an excess? As Chief Executive of the SMSF Association, John Maroney, argues:

> *"Constant changes to the superannuation tax settings erode confidence in the system and discourage members from making long-term savings plans."*

**3. Cost calculations assume no change in behaviour**

People respond to incentives. The calculations on the cost of superannuation assume a person with a personal marginal tax rate of 45% makes big tax savings by going into super taxed at 15%. Then this 30% tax saving is repeated for, say, 40 years on the super earnings to give the overall cost. Consider [this example from The Australia Institute]:

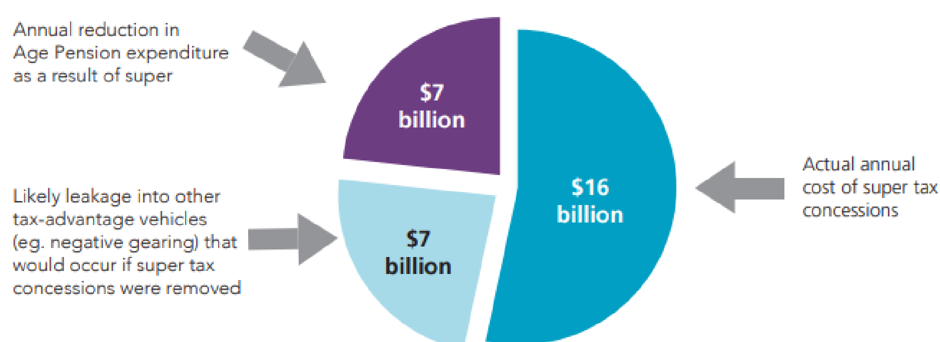
> *"Assume someone on the 45% marginal tax rate puts away $10,000 in real terms every year for 40 years into a fund earning 7.5% nominal or 5.0% after inflation of 2.5%. With the tax of 15% on contributions and earnings that person would have a sum of $784,310 at the end of 40 years. However, if the contributor had to pay the actual applicable marginal tax rate of 45% then the balance at the end of 40 years would fall to $306,496.8. The difference, $477,813.20 is due to the tax concessions on both the contributions and the income in the fund. Hence the taxpayer contribution accounts for 61% of the 'self-funded retirement' in this example."*

Two qualifications are needed on the overall costings.

**First**, the main reason for the large super balances is not the compulsory Superannuation Guarantee, the size of which is limited and today stands at only $27,500 a year. Large balances are accumulated due to non-concessional contributions (NCCs), which on several occasions in the past, were permitted up to $1 million. Even now, the downsizer contribution allows $300,000 per person or $600,000 per couple without counting towards the Total Superannuation Balance. These NCCs are made from after-tax dollars after tax was already paid at the marginal tax rate.

**Second**, the cost calculations take no account of how behaviour may change. In 2016, when the estimated cost of superannuation was about $30 billion, ASFA made the following calculations:

> *"When you take into account the savings the government makes on the age pension as a result of super, and the impact of behavioural change (people shifting money from one tax-effective vehicle to another) that would occur if super tax concessions were removed, a more accurate estimate would be around $16 billion a year. This is shown in the diagram below."*



Tax planners will find creative solutions to the cap, such as transferring balances to lower balance members in an SMSF. A common way to receive the income of large SMSFs at the moment is to set up a family trust or investment company to receive the pension payment and members draw out only what they need at their personal marginal tax rate, which in some cases may be nil.

With an estimated saving of $1.5 billion on the calculated cost of the superannuation system of $53 billion, is it worth all this effort and angst to save 2.8% of super's 'cost?'? The Stage 3 tax cuts which remain government policy will cost $254 billion over 10 years and they will benefit far more 'rich' people.

Even within superannuation itself, abandoning the scheduled increases in Transfer Balance Caps and Total Super Balances from 1 July 2023 would save more money, as would reducing the Division 293 threshold (where high-income earners pay higher tax on super contributions) from the current $250,000 to say $180,000, as super fund HESTA has advocated.

Instead, this proposal introduces another layer of complexity and Australians will turn more to expensive houses to capitalise on a competing tax advantage. Money out of super and into houses ... that's just what the country needs.

**4. Super high balances will reduce over time**

The strongest lobbying opposing the cap comes from the SMSF Association. This is to be expected because more of the 1.1 million members of SMSFs would be forced to divest money from super than in retail and industry funds. Chief Executive John Maroney argues that extremely high super balances are a legacy issue and limits on contributions imposed in 2017 will remove these balances as older members die.

When large balances built up by previous generations are passed to children, the money will need to leave the super system.

**5. The devil will be in the detail**

How might the proposed $5 million cap work? Let's check some potential implementation problems:

**a) Forced asset sales**

One proposal says amounts over $5 million should be withdrawn from super by 1 July 2024, but this may force asset sales. According to ATO statistics for SMSFs, over 10% of the assets of SMSFs with balances over $5 million (and over $10 million as the average number of people in each SMSF is about two) is in 'Non-residential real property'. Much of this is professionals such as doctors, lawyers and architects who run their business from an office which is owned by the SMSF. This asset is not intended to be liquidated and, in some cases, might comprise the majority of the fund.

A further 4% is in 'Residential real property' and about 15% is in 'Unlisted trusts', and some of these trusts, especially in alternative assets and commercial property, are tied up for long periods.

Funds already need to hold liquidity to meet pension payments, but some funds will not have ready cash to withdraw from the super system. Maroney says:

> *"It's our position that any proposal to restrict retention of extremely large balances in superannuation needs to be handled carefully to ensure that any rule changes allow adequate time to manage the restructuring that would be involved, especially where large illiquid assets are involved."*

**b) Tax on unrealised capital gains**

In the same way that balances are currently allocated between pension and accumulation and taxed accordingly, a third tier could tax earnings on asset levels proportionally above $5 million at the top marginal tax rate. This would avoid the need to sell assets.

However, tax is only payable on realised capital gains. If an asset has been held for many years, maybe decades, no tax has been paid on the unrealised capital gain. If the asset is sold when the balance is over $5 million, an SMSF may generate a huge capital gain. Will this be taxed at the maximum personal rate even if it has been held in super for 19 years of its 20-year investment life?

**c) Market falls reduce balances below $5 million**

As Chris Jordan identified, many of the larger balances are due to windfall gains on investments. It is common for start-up tech investments to be held in an SMSF, and if the value increases dramatically, the balance could surge past $5 million. But then in a tech crash, or if the start-up hits problems, it can fall just as quickly. Will a member go in and out of the $5 million cap and how will this be treated?

**d) Impact on downsizer scheme**

The Government proudly introduced the downsizer scheme to allow more money to move into superannuation, but a downsizer contribution does not count towards any caps and does not affect the Total Superannuation Balance. Does this mean a downsizer contribution that takes someone over the $5 million cap will have its earnings taxed at top marginal rates?

**This change is politically easy**

Changes which impose costs on a group of stakeholders usually face fierce opposition, but Stephen Jones is finding this one a walk in the park. Industry funds, retail funds and their lobby groups are supportive because the large balances mainly reside in SMSFs.

Of course, $5 million is a lot of money, but it is often the result of a multi-decade savings journey that a retiree has pursued with discipline on other spending, appreciating the impact of 30 to 50 years of compounding at decent investment returns. A house bought near a major city 40 years ago has improved by similar amounts. It’s prudent investing over a long time under a government-sanctioned retirement scheme, in the same super system which will encourage a couple to hold $4.2 million tax free by the same implementation date. Oh, that's fine, is it?

*Graham Hand is Editor-at-Large for Firstlinks. This article is general information.*

## Should I maximise my pension by investing in the family home?

### Jon Kalkman

In Australia there is no universal pension as exists in, for example, New Zealand. The age pension is designed to support the basic living standards of older Australians. It's not a recognition of taxes paid previously, although this is a popular perception. It's to stop older Australians living below the poverty line.

It is a welfare payment that targets pensioners by applying a means test. The amount of age pension paid is determined by both an **income test** and an **assets test.** Both tests are used and the lower pension is the one adopted. Both tests apply a threshold and income or assets above those thresholds will reduce the pension.

This discussion will focus on the assets test because not all assets are assessed.

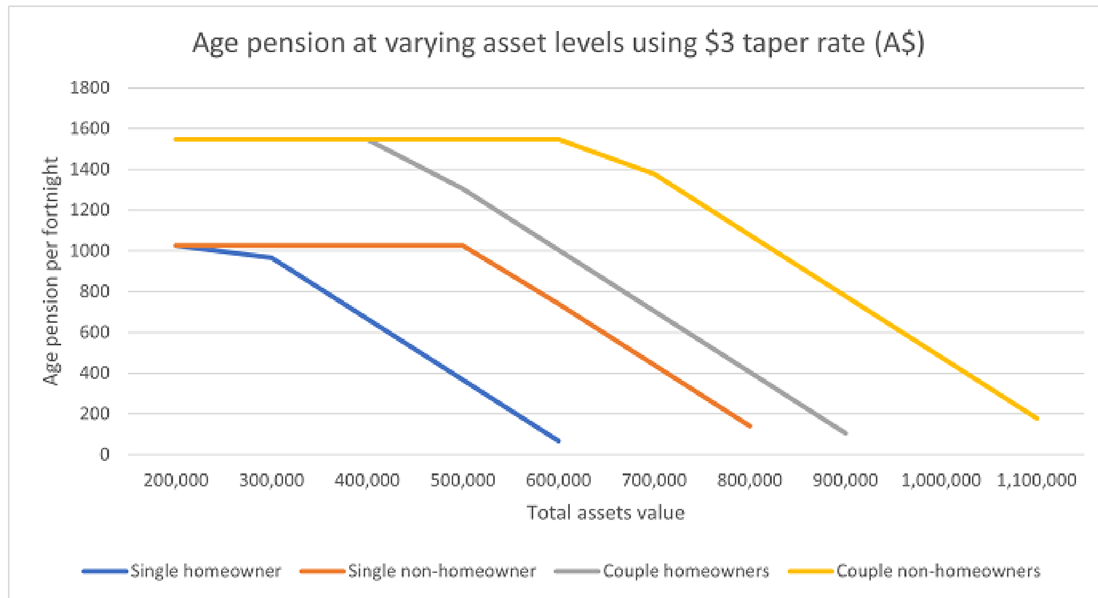
**Assets test**

To receive the full pension, assets must not exceed:

| | Homeowner | Non-homeowner | Pension F/n | Pension p.a. |
|---|---|---|---|---|
| Single | $280,000 | $504,500 | $1,026.50 | $26,689.00 |
| A couple, combined | $419,000 | $643,500 | $1,547.60 | $40,237.60 |

For both singles and couples, the pension is reduced by $3 per fortnight for every $1,000 over these thresholds. The part-pension is reduced to zero when assets reach:

| | Homeowner | Non-homeowner |
|---|---|---|
| Single | $622,250 | $846,750 |
| A couple, combined | $935,000 | $1,159,500 |




The rate of pension reduction - or taper rate - of $3.00 per fortnight is $78 per year per $1,000 over the threshold, or 7.8%. An additional $100,000 invested at 6% will reduce the pension by $7,800 but investment income is increased by only $6,000 (ignoring any tax impact).

The reverse is also true. A reduction of $100,000 in assets will increase the pension by $7,800 but only $6,000 in investment income will be forfeited. Unless homeowner couple pensioners can earn at least 7.8% on their investments, they maximise their total income (pension plus investment income) by having no more than $419,000 in assets.

Instead of encouraging and rewarding saving and accumulating assets in retirement, this taper rate encourages the reverse.

Prior to 2017, the taper rate was $1.50 per fortnight or $39 per year per $1,000 over the threshold, or 3.9%. In that case, pensioners had no incentive to reduce assets because spending it would reduce both their pension income and the capital available to be liquidated over time.

Following a review, the government changed the taper rate as it was alarmed by the number of millionaires receiving a part-pension. The change disqualified about 300,000 people from a part-pension. To soften the blow, the government gave these people automatic access to the Commonwealth Seniors Health Card (CSHC) which provides almost equivalent benefits to the Pension Card.

The other sweetener was to increase the lower threshold, the point where the pension starts to decrease. That was increased as follows:

- **Single:** $209,000 to $250,000 which is now $280,000 through indexation
- **Couple:** $296,500 to $375,000 which is now $419,000 through indexation

Changes to this threshold made more people eligible for the full age pension.

The government seems reluctant to change this perverse taper rate because a less punitive taper rate would create another round of millionaires eligible for a part pension and that would impact the budget and enrage the media.

**Investing in the family home may not be the best idea**

Pensioners need to navigate the current taper rate which incentivises the reduction in assets to increase income. The fact that the family home is exempt from the assets test gives a strong incentive to overcapitalise the family home by renovating or upsizing in order to maximise the pension.

There are some who advocate this strategy. They aim to have no more than the permissible amount in assets that ensures they receive the full pension with all remaining capital invested in the tax-free family home. According to this view, retirees would be better off financially by becoming pensioners using the taxpayer's money.

This strategy for self-impoverishment is short-sighted.

With the assets test, the only thing not counted is the family home. Everything else is assessed including house contents, the car, caravan and bank balances. To receive the full pension, a homeowner couple can have $419,000 in assets. If fully invested, they can earn 6% on say $400,000 or $24,000 on top of their pension of $40,000 or about $64,000 together. Many would consider that to be a comfortable retirement income.

The **first** problem with this strategy is there can be no spare cash for the next car, holiday or roof repair because it's all invested. Any spare cash in the bank will be assessed under the assets test and will not earn 6%. And, if some of this capital is spent, investment income is reduced without any compensating increase in the pension which is already at the maximum. There is also little capacity to rebuild those assets by returning to work.

**Secondly**, these pensioners then need to deal with Centrelink on a fortnightly basis and this means a loss of privacy and being subject to strict gifting rules. Such frequent Centrelink contact is not a pleasant experience.

**Thirdly**, because they are then totally dependent on Centrelink, these pensioners are as exposed to legislative risk as superannuants. The pension rules could change and they would have only limited capacity to respond unless they sell the family home, and that has its own complications.

By contrast, consider the couple who have $900,000 in assets. Using the same investment return, their income is $54,000 plus a pension of $2,719.60, but they have $900,000 of capital available to draw upon as needs arise. In fact, they are in the enviable position, where they can spend $100,000 and while they forfeit $6,000 in investment income, they gain $7,800 in additional pension income.

Self-funded retirees are even better off. Not only do they have more assets, but they don't need to deal with Centrelink. They have complete discretion over the disposal of their financial assets.

**What about a wealthier couple?**

Consider a couple who maximise their tax-free super pension accounts of (currently) $1.7 million dollars each, or $3.4 million together. That gives them a tax-free annual income, using the same investment return, of over $200,000. It is difficult to see why any rational couple would remove $3 million from their super fund to upsize the family home just to qualify for the full pension. Their income would fall from $200,000 to $64,000 and they would then need to answer to Centrelink for every change in their circumstances.

Of course, that calculation may be different for pensioners who only just miss out on the pension due to excess assets, but the motivation then is often simply to gain access to the Pension Card and not the minimal pension. Few realise the CSHC provides almost equivalent benefits for self-funded retirees and the eligibility rules have recently been relaxed.

Additional investment in the family home to maximise the age pension becomes a straitjacket. The age pension limits the assets available for investment and therefore investment income. In retirement, your lifestyle is defined by your income, not the size of your family home. Income provides choices in every sphere of life.

To voluntarily put yourself in that straitjacket, at the mercy of politicians and bureaucrats, comes at a high price in terms of reduced income, and loss of discretion over your own affairs. To do so just to receive a refund of your taxes seems ill-advised and injurious to a long and happy retirement.

*Jon Kalkman is a former Director of the Australian Investors Association. This article is for general information purposes only and does not consider the circumstances of any investor. This article is based on an understanding of the rules at the time of writing.*

## Banks are punishing the most vulnerable

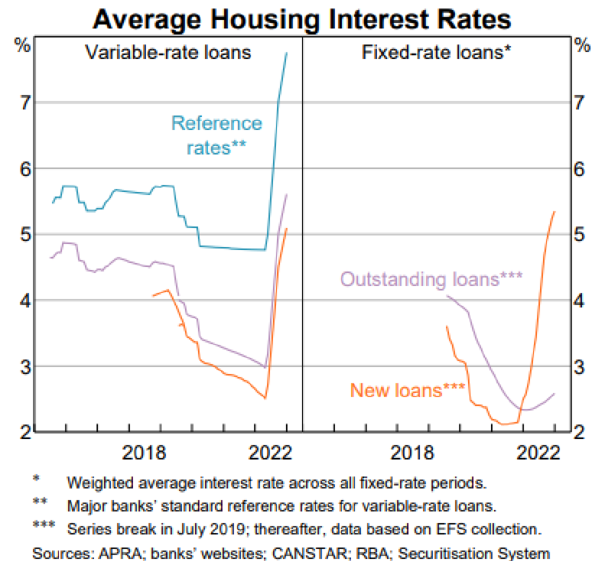
### Noel Whittaker

There's more bad news for homeowners. Interest rates are up again, with promises of more to come as central banks around the world play follow the leader. The effect on inflation is anybody's guess. Much of our inflation is entrenched - think the building industry - and many parts of household spending being non-discretionary. The rise in variable reference rates facing borrowers who come off low fixed rates is frightening.

The latest rise drew the predictable headlines, but once again, a major factor has been glossed over in the reporting. That is the way the big institutions have a feeding frenzy the moment people become vulnerable or get into trouble.

Think about a typical family who are doing their utmost to keep their finances in order. They are battling to cope with quickly rising prices on most things they need, along with multiple increases to their home loan repayments. Even with the best of intentions, they may easily fall behind in either or both their home loan repayments, and credit card repayments.

Even though banks spend a fortune on advertisements trumpeting that they wish to assist customers in financial trouble, the reality is entirely different.




**Raising rates on overdue loan amounts**

Many banks have a policy of moving home loans to a 'default interest rate' once borrowers are in arrears with payments. This means banks raise the interest on the overdue amount of a home loan purely because customers are having trouble making the payments.

But if they can't make the payments at normal interest rates, how can they possibly make them when the interest rate has been raised? It's not rocket science – this is kicking borrowers when they are down.

In fact, most banks outline their policies on raising rates on loan shortfalls (see below), and though these shortfalls may be small at first, they can quickly compound with variable rates of 7-8%.

**6.2 Default interest**

You must also pay us additional interest, called default interest on any amount you fail to pay by the due date under the Contract. We will calculate default interest on the overdue amount, i.e. any amount you fail to pay by the due date.

Default interest begins to accrue from the due date and then accrues daily until the amount is paid. For home loans/investment home loans the rate of default interest is equal to 2% per annum above the annual percentage rate applying at the time. For Viridian Line of Credit, please refer to clause O1.3/LOC1.3 for details on how we charge interest on any amount that exceeds the credit limit. We do not charge default interest on Equity Unlock Loan for Seniors.

*Source: CBA's Consumer Mortgage Lending Products Terms and Conditions, effective 15 December 2022*

**We'll charge default interest on amounts you haven't paid when originally due**

If we choose to charge default interest, we'll calculate it on all amounts you haven't paid when they were originally due. The default interest rate we'll use is set out in your loan summary. We calculate default interest at the end of each day, from the day the payment was originally due until the day you repay those amounts, including where we've obtained a Court judgment against you. We'll charge that default interest on the first business day of the next month.

*Source: ANZ's Home Loan Terms and Conditions*

**What default interest rate am I paying?**

Default interest rates are charged when a mortgage is in default. Consequently, all lenders will charge you a default interest rate on your home loan.

However, your loan contract will show how much you are charged for your default interest rate. Although, your interest rate would incur an extra mortgage arrears rate of between 3-5%. Hence, this default interest rate would be on top of your normal interest rate.

Indeed, some lenders will charge you a default rate on the arrears amount only. However, others will charge the default rate against the full loan amount owed. Hence, it is vital to make your payments on time. Consequently, a 4% interest rate could attract a 9% default interest rate.

*Source: The Loan Saver Network*

**Credit card practices are unfair**

Then there are credit cards. If the outstanding balance is not paid in full before the due date, the interest rate skyrockets to around 22%, backdated to when the goods were purchased. The interest-free period is removed. It gets worse, and relying on credit cards is a dangerous path. The borrower's credit rating will be shot, and it will become virtually impossible to switch a credit card to a cheaper provider. People will be stuck with an increasing debt at 22% and little chance of getting out of it.

This has been going on for years, and I've yet to meet any politicians who are willing to take on this predatory practice. Surely, it's a matter of fairness.

**The impact of rising rates and mortgage insurance**

It's not easy for people who are trying to protect their financial position. Think about a couple who shopped around for the lowest possible rate of interest on their home loan a year ago, before prices started to fall. If their deposit was less than 20%, they would have needed mortgage insurance – an expensive product with the sole purpose of protecting the lender, in the event of default by the borrower. That's correct: the borrower insures the lender, for the privilege of borrowing money! A fundamental problem is that mortgage insurance is offered by only a few specialist companies and is not transferable.

A borrower who has a loan with Bank A, and decides to change banks, will discover that a new mortgage - with the same borrower, same mortgage insurer, over the same security - will require them to pay a second premium, to insure their new lender, Bank B. And the cost of that second premium would normally be enough to make the shift uneconomic. They are locked in.

But there's more. This year, many homeowners will see their fixed loan rates expire and be faced with paying a much higher rate. Their deposit may have been sufficient to avoid mortgage insurance when they bought the house, but if the home's value has fallen due to interest rate rises forcing prices down, they may find that their deposit is now under the 20%. They are now locked into the existing lender.

Mortgage brokers tell me their existing bank will probably renew the loan if the borrowers are prepared to cop whatever interest rate the bank offers them. However, if they wish to change banks to get a cheaper rate, there will be the expense of a valuation, and then mortgage insurance, if the loan is approved. Once again, their only viable option would be to stay with their existing bank and cop whatever terms that bank decides to put on them.

The combination of rising prices due to inflation, and rising interest rates – which may be well be a futile mechanism to reduce inflation – mean that many families will be under extreme pressure. It's hard to think of any action more reprehensible than punishing them further with default loan rates and high credit card rates.

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## Meg on SMSFs: Is it better to wait until July to start your pension?

Meg Heffron

There has been plenty of media over the last few weeks about the fact that the 'transfer balance cap' will increase to $1.9 million from 1 July 2023.

This is the limit on how much anyone can put into a super pension after they retire. It started at $1.6 million in 2017 and increased to $1.7 million in 2021. The next leap will be to $1.9 million but only those who don't start any pensions until 1 July 2023 receive the full increase. Someone who starts a pension now and uses up their full limit of $1.7 million won't see any increase in July.

So many retirees with high super balances who were about to start pensions in their SMSFs are wondering if they should wait.

**Weighing up various scenarios**

Believe it or not, it depends.

One of the benefits of starting a pension as soon as possible is that the fund stops paying income tax on some or all of its investment earnings (dividends, rent, interest, capital gains etc).

Consider an SMSF with a single member, Joel, who has $2 million in super. Let's say Joel started a pension on 1 February 2023 with as much as possible at the time, $1.7 million. At the end of the year, an actuary will work out what proportion of the fund's investment income is exempt from tax in that first year. It's likely to be around 35% of all the income it earned during 2022/23 (even the rent, dividends, interest, gains etc. that it earned before the pension started).

Note that **next year** the percentage will be even higher, around 85%. It's lower in the first year to reflect the fact that the pension didn't start until the year was well progressed.

If the pension doesn't start until 1 July 2023, the SMSF (and therefore the member) will miss out on this tax break. So what is it worth?

That depends on how much income the fund earns in 2022/23. And remember we only look at the income that is taxed. The growth in the value of assets doesn't count unless the assets are sold because only realised capital gains are taxed.

Let's say Joel's SMSF earned $100,000 in rent, interest, dividends etc. during 2022/23. This equates to 5% of its assets. If Joel's pension started on 1 February 2023, the fund skips paying tax on 35% of this, or $35,000. As super funds pay tax at 15%, the value of the tax break is 15% x $35,000, i.e. **$5,250**.

On the flipside, what would be gained by waiting for the transfer balance cap to go up before starting the pension?

Joel will put an extra $200,000 into his pension and it will start at $1.9 million rather than $1.7 million. That means in *future* years the fund will receive an even higher tax break on its investment income.

For example, if the pension started at $1.7 million in 2022/23, the SMSF will be able to treat around 85% of its income as exempt from tax in 2023/24. It would be closer to 95% if the pension started at $1.9 million on 1 July 2023.

So what's that worth?

If we assume that the fund earns about the same taxable investment income in 2023/24 (say $100,000), the benefit of waiting is around $1,500. I worked this out by saying: the fund can treat an extra 10% (95% - 85%) of its income as being exempt from tax (10% x $100,000 is $10,000). Since super funds pay tax at 15%, Joel's fund will save **$1,500** (15% x $10,000) in the first year if he doesn't start his pension until 1 July 2023.

Then some saving like this will happen in every subsequent year. If we wait long enough, it's highly likely that waiting will be a better option.

But a few points leap out.

**Firstly**, the saving is quite small. So those who started their pensions in 2022/23 need not feel they have made a tragic error. Even if we model for five, 10 or 15 years into the future allowing for variables that impact the calculations (for example, future investment returns, pension drawings, inflation and more), waiting is better by thousands or tens of thousands of dollars but not hundreds of thousands.

**Secondly**, it will take three to four years before the savings from waiting until 1 July 2023 add up to more than the savings from starting on 1 February. A lot could happen in that time.

**Other things to consider**

In this comparison, we're looking at someone starting a pension in February with five months left in the current financial year and a high percentage of tax-exempt income (35%). As we move closer to the end of the year, the decision will be easier - waiting until July will be better. That's because the actuarial percentage is lower if the pension doesn't start until later in the year. Someone starting in June, for example, will have virtually none of the fund's income treated as being exempt from tax in 2022/23. They have nothing to gain by starting early.

It depends on how much taxable income the fund earns this year versus next year. What if this SMSF had sold a large asset and made a big capital gain in 2022/23? Perhaps the fund's taxable investment income is normally around $100,000 but this year it will be $300,000? In that case, the member should probably start their pension as soon as possible to make sure that 35% of $300,000 ($105,000) is exempt from tax, saving

$15,750 in 2022/23. If the fund's income reverts to normal in the subsequent years, it will take many years of $1,500 savings to make delaying more attractive.

Overall, I would say that – all other things being equal – waiting is probably better but not by as much as it might appear. Certainly, it will take a while to feel that way and it's worth doing the calculations to be sure.

*Meg Heffron is the Managing Director of [Heffron SMSF Solutions](), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.*

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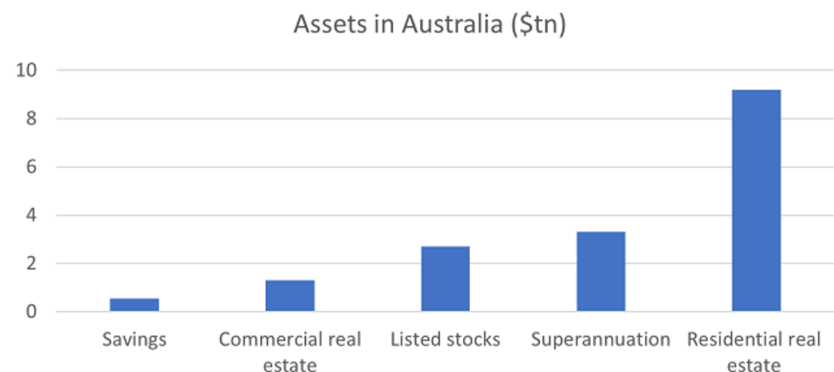
## There are good reasons interest rates need to rise

### James Gruber

Higher interest rates are political dynamite in Australia. That's hardly surprising when 67% of households own homes, 57% of total wealth is in housing and household debt levels are amongst the highest in the world. Powerful real estate lobby groups and the governments and media beholden to them aren't particularly happy about the prospect of more rate rises. Just ask RBA Governor, Philip Lowe, whose job is on the line because of it.




There's barely a mention of the benefits of higher rates. People who've worked hard and saved money instead of taking on debt can now earn decent interest on their savings, asset bubbles in everything from stocks to real estate to crypto which caused all kinds of problems have popped, the gap between rich and poor has started to turn thanks to lower asset prices (the rich own these assets), wages are finally increasing, the scourge of inflation and higher prices are being targeted and loss-making businesses are dying after being kept alive for too long thanks to low rates.

That these points aren't given much airtime highlights the often confused and one-side debate about interest rates. This article is an attempt to redress that and provide historical context to today's situation.

**The most important price in the world**

Let's first define what interest rates are. They are the price of money and arguably the most important price in the world. Everything in finance and the economy is based off them.

If you lend money to a bank, you expect to be paid for losing the use of your money. If you borrow money from a bank, you expect to have to pay for being able to access the money immediately. That's why Edward Chancellor in his latest book on the history of interest rates, suggests rates are the 'price of time'.

It's ironic that though interest rates are central to capitalist societies, they aren't determined by the free market. Instead, they are 'fixed' by central banks.

In Australia, the RBA determines the 'cash rate' and reviews the rate on the first Tuesday of each month except January. The cash rate is the rate used by the RBA for short-term lending and borrowing between banks. It's a baseline for all interest rates in the market. A change in the cash rate by the RBA is significant because it signals the RBA's views on the state of the economy. If the economy is too weak, the RBA will lower the cash rate to stimulate growth. And vice versa.

**A brief history of interest**

The conventional view of history books is that the barter trade system, where you swap one good or service for another, came before the arrival of loans and credit.[1] Yet newer evidence suggests that loans and interest

have been with us from the beginning of time. Well before the advent of coined money in the eighth century BC, for instance.

About 5,000 years ago, Mesopotamians charged interest on loans, and this was before they had discovered how to put wheels on carts. We know this because they recorded their loans on clay tablets. These tablets reveal detailed loan arrangements, not too dissimilar to modern loan documents. They recorded names of debtors and creditors, loan amounts, dates, repayment due dates, interest charged, and the collateral attached to the loan.

The loans back then were most likely for corn and livestock – loaning farm animals, for example, and charging interest on that. The word 'capital' comes from the Latin word *caput*, meaning head of cattle. This prompted authors, Sydney Homer and Richard Sylla, to suggest interest originated from:

> *"…loans of seeds and of animals. These were loans for productive purposes. The seeds yielded an increase. At harvest time the seed could conveniently be returned with interest. Some part or all of the animal's progeny could be returned with the animal. We shall never know but we can surmise that the concept of interest in its modern sense arose from just such productive loans."*

But it's clear that loans proliferated on many things. And the reason is simple: capital was in short supply.

From the earliest days, interest on loans was required to induce people to lend their resources. Without this interest, they would have invariably hoarded their capital.

That's why financial historian William Goetzmann suggests:

> *"The emergence of interest to incentivize lending is the most significant of all innovations in the history of finance."*

While innovative, interest and the moneylenders who profited from it have had their share of enemies from the start. English jurist and politician, Sir William Blackstone said in 1765, "When money is lent on a contract to receive … [there is] an increase by way of compensation for the use, which is generally called interest by those who think it lawful, and usury by those who do not".

The Old Testament has several famous passages on usury:

> *"Thou shalt not lend thy brother money to usury, nor corn, nor any other thing."*
> *"If thou lend money to any of my people that is poor, that dwellth with thee, thou shalt not be hard upon them as an extortioner, nor oppress them with usuries."*

Indeed, the Hebrew word for usury is 'to bite'.

Ancient philosophers also frowned upon interest being charged on loans. Aristotle described usury as immoral as 'money was intended to be used in exchange, but not to increase at interest'. And Plato depicted usury as setting rich lenders against poor borrowers.

In Ancient Athens, professional moneylenders had low social standing, and bankers weren't popular either.

**The 'right' interest rate**

The necessity of interest has been an emotive debate from ancient times. So has the level of interest rates.

Some believe interest rates derive from the returns on real assets. Others see population growth and changes in national incomes as key drivers of rates. While many think market forces of supply and demand are at play.

A recent study by the Bank of International Settlements argues interest rates over the past 100 years has been influenced more by monetary regimes, such as the gold standard, Bretton Woods, and dollar standard, than by economic factors such as investment decisions.

There's no consensus on the topic.

The raising or lowering of interest rates has drawn plenty of opinion at different stage of history. In the 1660s, England was struck by the Great Plague of London that killed 100,000 people, the Great Fire of London that gutted the city, and the financial extravagances of Charles II – which eventually resulted in a default of England's sovereign debt.

A businessman, Joshua Child, had a solution to England's woes. He proposed a decline in interest rates as 'an abatement of interest would tend to the increase of trade and advance the value of the lands of England'.

Child's book, Brief Observations Concerning Trade and the Interest of Money, became one of the most popular books on economics during the 17th century.

Critics charged that a reduction in interest would only encourage money hoarding. And pamphleteers at the time pointed out that interest on capital was comparable to rent on land.

Later, the famous philosopher John Locke entered the debate with his book, Some Considerations of the Consequences of the Lowering of Interest and the Raising of the Value of Money. Locke argued that lowering interest below its natural level would have many undesirable outcomes, including:

- Wealth would be redistributed from savers to borrowers
- Bankers would hoard money rather than lend it out
- Money circulation would decline, and prices would fall ie. deflation
- Too much borrowing would take place
- Asset price inflation would make the wealthy wealthier
- Lowering rates would fail to revive a spluttering economy

**The ghost of John Locke after 2008**

When the Global Financial Crisis hit in 2008, many central banks in the West cut their interest rates to close to zero. They also bought government bonds and other securities, otherwise known as quantitative easing. These measures were an attempt to revive economies that had been smashed by the biggest banking crisis since the 1930s.

After their economies had mostly recovered, they kept these emergency policies in place. In fact, interest rates were kept near zero for much of the period from 2008 to 2021. To put it into perspective, interest rates globally dropped to their lowest point ever. They were the lowest they've ever been in Australia too.

Never in history has there been such a sustained period of negative yielding bonds. At the peak in 2020, there were US$18 trillion in negative-yielding bonds. In February 2020, Louis Vuitton raised more than US$10 billion in bonds to finance its purchase of luxury jeweller Tiffany, some of which carried negative yields. In other words, some banks were paying Louis Vuitton interest on debt to finance its purchase of another company.

The extreme policies enacted by central banks resulted in outcomes that John Locke foresaw some 320 years ago. Low interest rates spurred soaring asset prices, rising inequality as the rich benefited from owning these assets, an explosion in borrowing, banks hoarding rather than lending money, and low inflation as money circulation slowed.

It took a pandemic and the mind-boggling printing of money in the US – with money supply increasing 25% year-on-year at one point – to bring about the economic revival that central bankers so desperately wanted. But it's come with a predictable side effect: inflation peaking at high single digits.

**Where we now sit**

Australia finds itself in a difficult predicament. Australians have borrowed too much to buy homes. Rising interest rates will soon result in financial distress for many. And our economy is too reliant on housing. After all, the total value of residential property at $9.2 trillion dwarfs our annual GDP of $1.55 trillion. Crash the housing market and it'll crash the economy. Therefore, rates can't go too high.

But then there's inflation. Letting inflation run is dangerous. Many countries and civilisations have fallen because of rampant inflation and the devaluation of their currencies.

Getting the level of interest rates right will be a treacherous balancing act. And it's unlikely to be solved by stalling a new RBA Governor and pressuring them to lower rates.

Yet it needn't have come to this had Australian and other central banks pursued more orthodox economic policies up to 2021.

How it plays out from here may well be one for the history books.

[1] Much of this history has been sourced from Edward Chancellor's book, *The Price of Time*.

*James Gruber is an Assistant Editor at Firstlinks and Morningstar.*

## Five proposed changes to superannuation

David Knox

The taxation of superannuation in Australia is complex, inequitable, and subject to regular change. These features reduce the long-term confidence of Australians in their superannuation system. We can and should do better. This article proposes:

1. Paying Superannuation Guarantee (SG) contributions on all government-paid parental leave funded by reduced super tax concessions
2. Extending the Low Income Superannuation Tax Offset (LISTO) so that it fully compensates those earning up to $45,000 for tax on their superannuation contributions
3. Reducing the Division 293 tax threshold from $250,000 to $225,000
4. Introducing a maximum superannuation benefit at age 70 of $3.4 million
5. Requiring all superannuation benefits be subject to minimum drawdown rules from age 70.

**The current superannuation tax arrangements**

A good starting point to review the current tax arrangements for superannuation is to briefly describe the existing rules that apply to most Australians. It is also helpful to separate those rules that apply during the accumulation (or pre-retirement) years and the pension (or post-retirement) years.

***Accumulation years***

**Contributions paid into super**

- From the employer or from an individual where a tax deduction is received
  – Taxed at 15% at most income levels
  – Capped at $27,500 pa, except for some catch up rules

- From an individual where a tax deduction is not received (i.e. from after tax money)
  – No further tax on the contribution
  – Capped at $110,000 pa

**Investment income (received by the super fund)**

- Taxed at 15% with a 10% tax on realised capital gains
- Reduced by tax deductions for expenses and offset by franking credits

***Pension years***

**Investment income (received by the super fund)**

- No tax is paid on earnings on pension products with a starting limit of the Transfer Balance Cap (i.e. a current maximum retirement benefit of $1.7 million per person)
- For balances not in pension products: taxed at 15% with a 10% tax on realised capital gains, reduced by tax deductions for expenses and offset by franking credits

**Benefits paid from super**

- Tax free on all benefits paid after age 60 (lump sums or pensions), except for some death benefits

**Proposals to improve the super system**

**1. Super Guarantee on paid parental leave**

Under current legislation Superannuation Guarantee (SG) contributions must be paid on most forms of leave, including annual leave, long service leave and sick leave. Yet, these compulsory super contributions are not required on paid parental leave, whether paid by the government or an employer.

This is unreasonable and disadvantages many more women than men.

**Recommendation**

- Require that the SG be paid on all government-paid parental leave
  *The net cost to the Government based on the long-term SG rate of 12% and allowing for the 15%*

*contribution tax is approximately $0.36 billion [estimated using data in the Budget Papers October 2022-23].*

**2. Low Income Super Tax Offset**

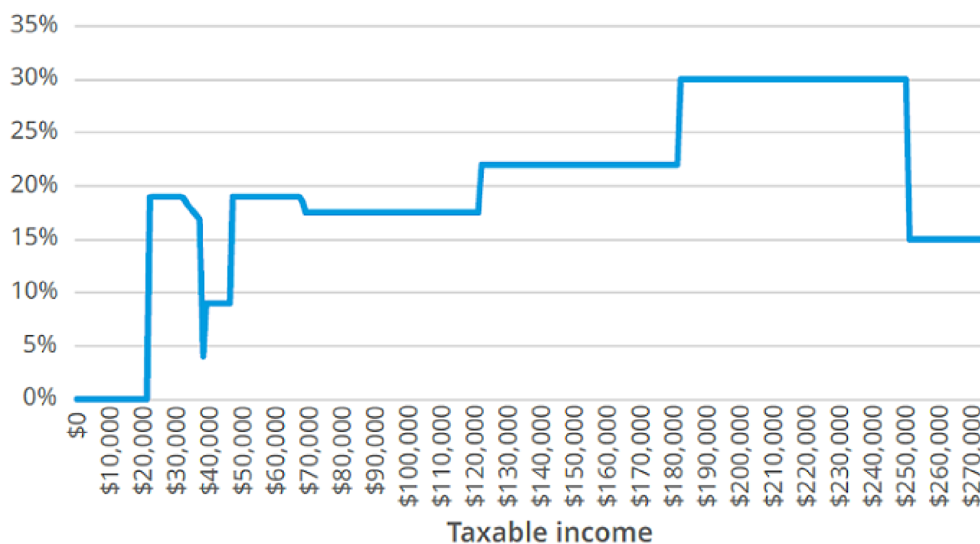
Concessional contributions, subject to an annual cap of $27,500 (plus some carry-forward contributions, where eligible), are generally taxed when received by the superannuation fund at a flat rate of 15%. This is the less than the marginal tax rate for all income taxpayers.

The low-income super tax offset (or LISTO) is paid to those with an adjusted taxable income of $37,000 or less. The offset equals 15% of the individual's concessional contributions, thereby removing the tax on contributions, subject to a maximum of $500.

The value of the tax concession provided to individuals on their concessional contributions is the difference between the individual's marginal tax rate and the tax paid on their super contributions.

Figure 1 shows the value of this concession, expressed as a percentage of the concessional contribution, for each level of taxable income, assuming the current SG contribution rate of 10.5%. This graph assumes the person is single (with no dependants) and ignores the Medicare levy, as well as any impact relating to private health insurance.

**Figure 1:** The current value of tax concessions on concessional contributions for 2022-23




*This graph is a simplified form of a similar chart in the Retirement Income Review (Chart 3A-1) which used an effective income tax threshold of $21,884 for 2019-20. The above chart uses the same threshold given the abolition of the low-medium income tax offset after 2021-22. This graph is based on taxable income and not the definition of Division 293 income that applies at very high incomes. Hence, the graph overstates the level of the concession for someone whose taxable income is under $250,000 but where their Division 293 income exceeds $250,000. The Retirement Income Review also adopted this approach.*

It is apparent that there are several anomalies in the current arrangements, including:

- There is no concession or advantage received by individuals with an income below $21,884 after allowing for the low-income tax offset. These individuals receive no tax concession as they pay no income tax and also pay no tax on their super contributions due to LISTO.
- Due to the inconsistencies between the threshold under LISTO (i.e. $37,000) and the second income tax threshold of $45,000, individuals with incomes between these two figures receive a lower concession.
- The LISTO cap of $500 is less than the tax payable on the 11% SG contribution in 2023-24 for individuals with incomes above $30,303.

**Recommendations**

- Increase the income threshold for LISTO from $37,000 to $45,000 to match the second income tax threshold.

- Increase the maximum LISTO payment from $500 to $810 to match the tax payable on a 12% SG contribution for an income of $45,000.
  *The cost of this change is approximately $0.52 billion per year [based on Mercer analysis from data in ATO, 2% sample unit record file of individual tax returns, 2019-20].*

### 3. Division 293 tax

Figure 1 showed those with taxable incomes between $180,000 and $250,000 receive the highest tax concession on their concessional contributions. In fact, it is more complicated than this as the extra 15% tax arising from Division 293 uses adjusted income, which includes concessional contributions and other items. Hence, the graph overstates the level of the concession for an individual whose taxable income is under $250,000 but where their Division 293 income exceeds $250,000.

Notwithstanding this complexity, many individuals whose taxable income is between $180,000 and $250,000 receive the highest level of taxation support for their concessional contributions.

**Recommendation**

- Reduce the Division 293 threshold from $250,000 to $225,000. This is 25% above the highest income tax threshold, thereby allowing for the maximum level of concessional superannuation contributions and other items used in the definition of adjusted income.
  *This measure would raise additional revenue of approximately $0.22 billion [using data from the ATO, 2% sample unit record file of individual tax returns, 2019-20].*

### 4. Capping the size of super benefits

There are various limits within the superannuation system relating to the level of contributions. However, there are no limits in respect of benefits. The Retirement Income Review noted that:

> *"At June 2018, there were over 11,000 people with a balance in excess of $5 million.* ***People with very large superannuation balances receive very large concessions on their earnings.****" (their emphasis)*

The Review observed that certain tax concessions are not cost-effective. The implication is clear. The introduction of some form of benefits cap would limit the significant concessions received in respect of investment earnings by those with very large balances.

This leads to two questions:

1.What is the maximum retirement benefit that should receive full tax exemption on investment earnings during retirement? This is the Transfer Balance Cap (TBC) on amounts transferred to pension accounts and is currently $1.7 million, going up to $1.9 million on 1 July 2023.

2. Should there be an additional benefit cap above the TBC (i.e. on the total balance in super, not just in pension accounts?) If so, what should the cap be?

The second question relates to the appropriate tax treatment of superannuation balances outside pension products (i.e. beyond the TBC). Currently, investment income from these superannuation balances is taxed at 15% (10% for capital gains) which represents a tax rate below the lowest marginal tax rate.

The financial position of retirees with superannuation balances above the TBC varies significantly. Some have limited income outside superannuation whereas others may have significant income from investment portfolios or ongoing employment. Hence, the appropriate tax rate on investment earnings on these super balances varies significantly. There is no 'correct' answer for all retirees.

The recommendation is for retirees to retain up to $3.4 million within the superannuation system. This total figure should be indexed annually (as currently occurs with the TBC) so that its real value is maintained.

The next question is how to apply such a cap. As with the TBC, it should be a one-off test and not repeated during retirement. In addition, a transition period is needed to avoid forced disposal of assets such as property in the short term, which may be particularly relevant for SMSFs.

**Recommendation**

- Require all individuals at age 70 to reduce their TSB to $3.4 million.

The introduction of the additional cap would raise revenue of approximately $0.70 billion, after allowing for some behavioural change.

Following the introduction of this cap, individuals currently aged 70 or over would be given three years to reduce their total superannuation balances to the legislated cap.

The application of this cap should also prevent these individuals from subsequently making a downsizer contribution into their superannuation account.

**5. Minimum drawdown rules to apply to all super**

There are currently no minimum drawdown rules applied to the balances in excess of the TBC, irrespective of the age of the member. Applying the minimum drawdown rules to the total balance would reduce the scope for superannuation to be used for estate planning.

**Recommendation**

- Require the minimum drawdown rules to apply to all superannuation balances from age 70[3].

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[1] We have used 31 years for the retirement period as it represents the average life expectancy from the preservation age of 60 (ABS, Life Tables 2019-2021) plus 5 years, which recognises that half the population will live beyond the average life expectancy. In addition, we expect individuals who have these above average benefits will receive little or no Age Pension so that the eligibility age for the Age Pension is not relevant.

[2] This value assumes that the pension is paid for 20.0 years based on the latest ABS life expectancy figures at age 67. The use of a wage related deflator simplifies the calculation as the Age Pension is linked to average wages.

[3] Age 70 is suggested as it is between the Age Pension eligibility age of 67 and age 75, which is the maximum age permitted to make non-concessional contributions without a work test.

*Dr. David Knox is a Senior Partner and Senior Actuary at Mercer Australia. This article is general information and not investment advice, and does not consider the circumstances of any person.*

## Defining contrarianism in three stocks

### Eric Marais

What do Galileo Galilei and a member of the flat earth society have in common? The answer, we think, goes to the core of how contrarian investing works.

While both reject the accepted view of the world, flat earthers' views seem to stem from a scepticism of the prevailing order and an unwillingness to accept the facts laid out for them. Galileo's objections, on the other hand, were based on the rigour of fundamental research. He was willing to stand apart from the crowd, but that wasn't his goal, it was the natural outcome of his bottom-up research.

In the same way, contrarian investing isn't just about blindly betting against the crowd – most of the time stocks are cheap for a reason – it is about being willing to look differently in the short term to stack the long-term odds in your favour.

In simpler terms, it is about having the courage to buy when others are fearful and the discipline to sell when others are greedy. The trick to remaining contrarian throughout the market cycle is being able to do it consistently in both directions, even when the market is against you.

Although there are many reasons why markets might overlook a company, a few come up regularly. Here we outline examples using some of the opportunities we've been uncovering in Japan and Korea.

**Too much focus on short-term headwinds**

Korea's leading online broker, Kiwoom Securities, is a good example of this. The stock currently trades at 0.6 times its trailing book value and 4 times normal earnings. This is largely because investors have been concerned that the challenging stock market that faces us all is likely to negatively affect the company's profits in the short term. We don't disagree, but if you look beyond these short-term concerns and focus instead on

management's track record of delivering outstanding fundamental growth and the attractive business opportunities available to Kiwoom – the potential looks compelling.

**Kiwoom Securities Co Ltd stock price chart, 5 years**

*Source: Morningstar*

Kiwoom's management appears to share our view, having launched two opportune share buyback programmes last year—only the second and third buybacks in the company's entire history. We typically take a positive view of a decision to repurchase shares, both because it increases the intrinsic value of the remaining shares and since it is often a sign of confidence in the outlook for the long-term fundamentals of the business.

Furthermore, the firm's earnings and dividends could inflect in the years ahead, thanks to welcome regulatory relief. Recently, a new government has acknowledged the 'Korea discount' on the country's shares, and seems prepared to take steps to remove it, for example by improving access to foreign investors by relaxing special ID registration. Should this occur, Korean shares could enjoy higher valuations.

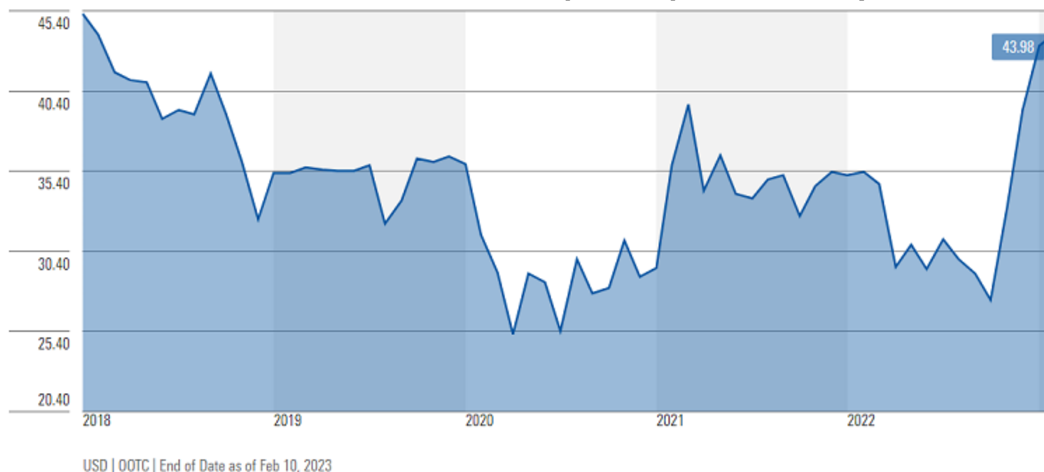
**Focusing on 'sectoral woes' rather than individual prospects**

Banks are a classic 'value' sector that stand to benefit from favourable exposure to a changing economic regime, yet the sector is down more than 10% this year. Over the last 13 years, near-zero interest rates hurt banks' lending margins, while regulations have limited their growth and payouts to shareholders.

But as the environment shifts, we have found increasingly compelling opportunities among banks globally, but particularly in Asia where financials generally seem a bit behind those in Europe and the US.

On current profits and payouts, banks like Sumitomo Mitsui Financial Group in Japan, trade at 8-9 times earnings, with dividend yields of about 4%—which is already appealing. Japanese banks tend to have their balance sheets in order, they're relatively well-capitalised, and they're in a supportive environment where regulators want them to earn more money and are happy for them to pay that out to shareholders.

**Sumitomo Mitsui Financial Group stock price chart, 5 years**




*Source: Morningstar*

But where Japanese banks could truly shine is if interest rates rise in Japan. With inflation now running well above the official 2% target and the Japanese yen having touched decades-low levels against the dollar, the Bank of Japan may soon have to raise interest rates.

If they move from zero to 2%, the earnings of Japanese banks could approximately double, leaving them on 4-5 times earnings with 8-10% dividend yields—which in our view is far too cheap. With the stocks trading at a 40% discount to book value today, we pay very little for that upside potential. When, or indeed whether, such a policy shift may come, we cannot be sure. But we think there are positive signs of change.

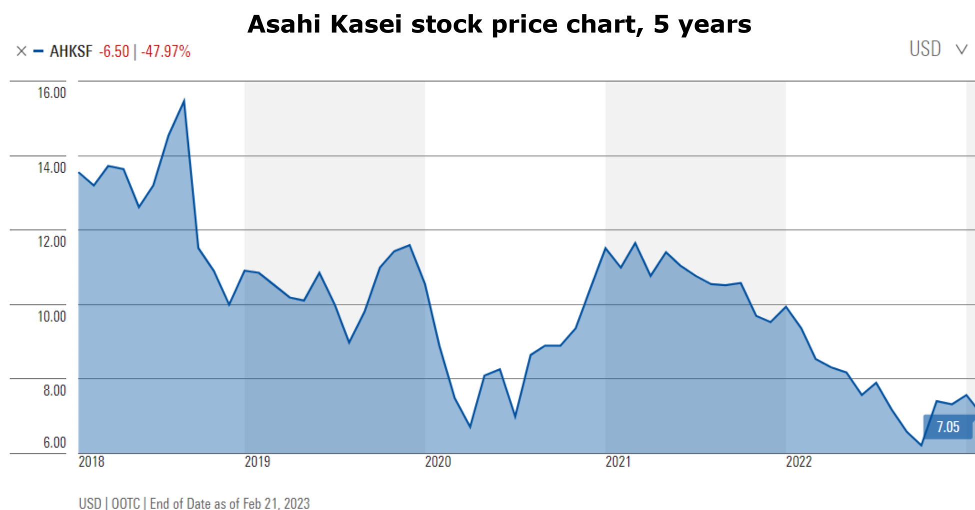
**Focusing on the glamour rather than the growth**

There are several examples within our portfolios of companies that we believe are trading for less than they are worth because they are in unglamourous industries like materials or manufacturing. A consequence of 'The Great Misallocation' that we've talked about previously, where market sentiment has driven money towards more wasteful places rather than more useful places.

In this environment 'boring' businesses are often overlooked despite generating exciting profits, in favour of more interesting 'story' stocks. Take Asahi Kasei, a Japanese chemicals-oriented conglomerate, for example.

In 2015, shares of Asahi Kasei were under a cloud due to a data falsification scandal in its concrete piling business—a small subset of its wider housing unit, which accounted for 30% of the company's profits at the time. We believed the market was overreacting. In most regions, the company had stopped selling precast concrete piles in 2013, and the company's main housing brands used an entirely different construction method to the houses affected by the scandal. Leaning against the pessimism, we were able to buy the company at near-record low valuations relative to the Japanese market, which was rewarding as the clouds lifted in time.

**Asahi Kasei stock price chart, 5 years**




*Source: Morningstar*

Now, one of Asahi Kasei's crown jewels is a US-based medical device company called Zoll Medical. Zoll sells a range of products centred on defibrillators and other devices used for critical care, including a wearable 'LifeVest' for patients at risk of sudden cardiac arrest. Protected by patents and supported by a large sales and distribution network, LifeVest gives Zoll a formidable competitive position, helping the company earn operating margins in excess of 20%. And Zoll is not the only part of the company's healthcare business. In total, we believe this sector alone accounts for roughly 100% of Asahi Kasei's current market cap despite only accounting for one quarter of its operating profit – which seems exciting to us.

**A disciplined investment process**

This also provides a good segue to the other side of the contrarian coin – the need for discipline when markets are heading off in the opposite direction.

Much of our focus remains on price and, importantly, whether we think the stock is trading below what we think it is worth. Over our 30-year history, there have been lots of companies we would have loved to own, had they been cheaper. But because they were too expensive, we stayed away.

In 1990, for example, we had no Japanese holdings, even though the Nikkei made up 42% of the global index, while in 2000, our exposure to so-called TMT (Technology, Media and Telecom) stocks was only 2%, compared

to a 40% weighting in the global market. And, more recently, we were significantly underweight US stocks. In 2021, US stocks accounted for 66% of the world index but only around 30% of our portfolio - a position that made the past few years decidedly painful.

But as 'The Great Misallocation' that we've witnessed in markets starts to unwind, and valuation gaps start to close, we think our active, contrarian approach to stockpicking, with a focus on business fundamentals and valuations, will allow us to uncover many more opportunities like the ones described above.

*Eric Marais is an Investment Counsellor at Orbis Investments, a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.*

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