Firstlinks

a Morningstar company

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Contents

Editorial

What a week for the **500th edition of Firstlinks**! The biggest US bank collapse since the GFC in 2008 put the skids on markets. More on that and the implications for interest rates later.

To mark our milestone, three special pieces outside our normal content:

- Rather than reminisce ourselves about the past 10 years, we publish an extract from a forthcoming book by **Greg Bright**, well known to industry participants for four decades of publishing on wealth management. Plus an interview with me by media company, **Telum Media**.
- A new and free eBook to ponder over a Sunday coffee where we ask 30 fund managers, ***"What part of your investment process has contributed most to identifying winners?"***
- A Reader Survey, the first we have conducted in many years. Please help us to understand more about who you are and what you would like to read on investing, asset management, retirement saving, etc.

The first edition was published on 8 February 2013 so that's about 50 editions a year, with a break for Christmas. Phew! All our content is online in a searchable archive.

Here's how the All Ords Price Index has changed since we started. It has risen 44% in 10 years, with losses in three of the last nine years and 2023 down to date. The per annum return of the price index is 3.6%, while the total return index is up 7.9%, which shows how much returns rely on dividends.

Total Return %	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD
Index (Price)	14.76	0.66	-0.82	7.01	7.84	-7.42	19.14	0.71	13.55	-7.17	-0.29

To put all this in an overall wealth context, the big asset numbers are:

- Australian listed securities, $2.8 trillion
- Residential real estate, $9.3 trillion
- Superannuation assets, $3.4 trillion
- Commercial real estate, $1.3 trillion

It explains why most of our interest rate discussions focus on the implications for residential property which dwarfs other asset classes in Australia.

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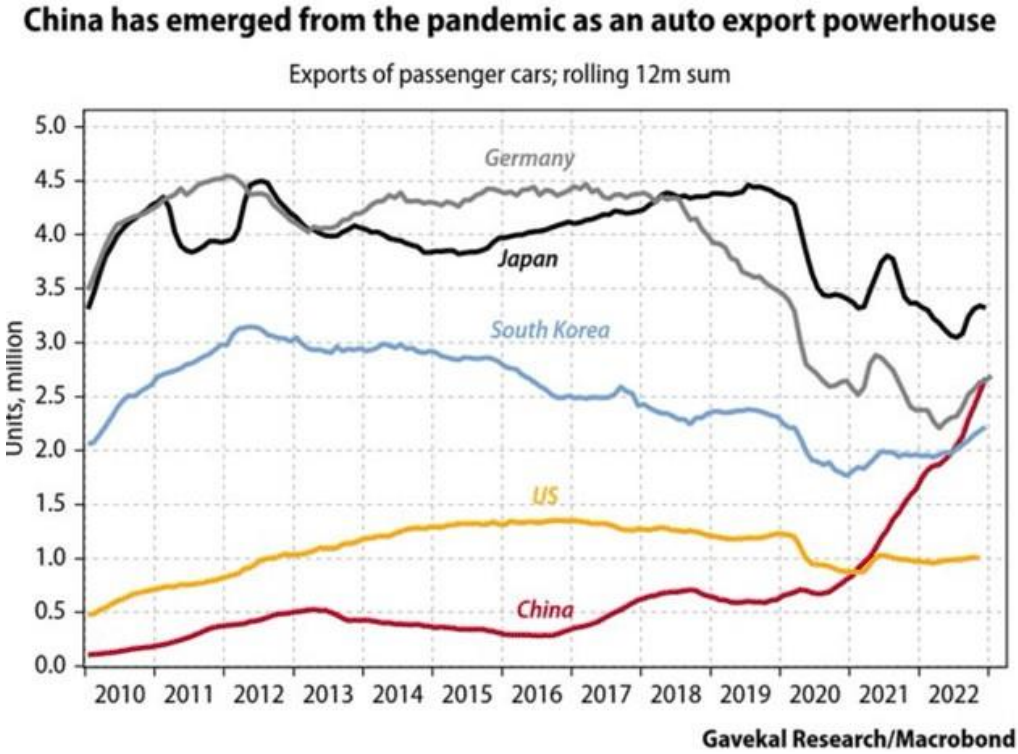
The **AUKUS** announcement and a substantial boost to Australia's equipment manufacturing capability brings another historical change into perspective. A few months after we started publishing, in May 2013, **Ford** announced it would cease production of motor vehicles in Australia by 2016. The final **Holdens** and **Toyotas** rolled off the local production lines in 2017.

At that stage, Chinese cars represented less than 1% of cars sold in Australia, and now the share is over 10%. A few years ago, it would have been difficult to argue China would soon overtake Germany and South Korea as a car export powerhouse, and it's mainly due to EVs. We are changing our minds about the quality of cars built in China, as all Australian-delivered **Tesla** Model 3s, the **Polestar** 2 and most **Volvo** XC40s and XC60s are made in China. Markets and competitive advantages can change quickly.



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The new tax on super above $3 million dominated the headlines for a week or two but submarines and bank collapses have pushed super down the line. But with advisers already planning new strategies and large super holders reviewing whether to hold wealth in super, it's important to understand the implications. There is no legislation yet and implementation is beyond the next election and plenty can change, so it is premature to take action.

This week's article by **Ashley Owen** shows how someone in the top marginal tax bracket and subject to the new $3 million rule may pay more marginal tax in super than outside. It seems intuitively wrong but Ashley's calculation uses a typical portfolio and past returns to show the impact of taxing unrealised capital gains.

Here is an example of a strategy already used by financial advisers which will become more prominent (I am not recommending this, just sharing it):

- Where a Condition of Release has occurred, cash out the amount in excess of $3 million.
- Move the money into a Discretionary Family Trust (DFT) which includes a company as a beneficiary.
- Pay the income from the DFT to the company beneficiary which pays tax at 30% (or to any family member with a marginal tax rate at or below 30%)

Tax is still paid at 30% but only on realised gains and it also removes the risk of paying the 17% 'death tax' when super is not paid to a dependant. Treasury should expect a significant increase in the use of DFTs, or maybe there will be a restriction.

It shows that when Treasury prepared its estimate of the cost of superannuation concessions at $50 billion a year, based on an assumption that the highest income earners will pay tax at 47% outside super, it is vastly overstated. The Stage 3 tax cuts will also bring far more people down into the 30% bracket and encourage a move out of super.

We explain why Treasury adopted the taxing of unrealised capital gains as its recommended and 'simple' measurement method. They were faced with the dilemma that most people and the ATO do not know how much tax they pay on super, yet the tax is implemented at the individual level.

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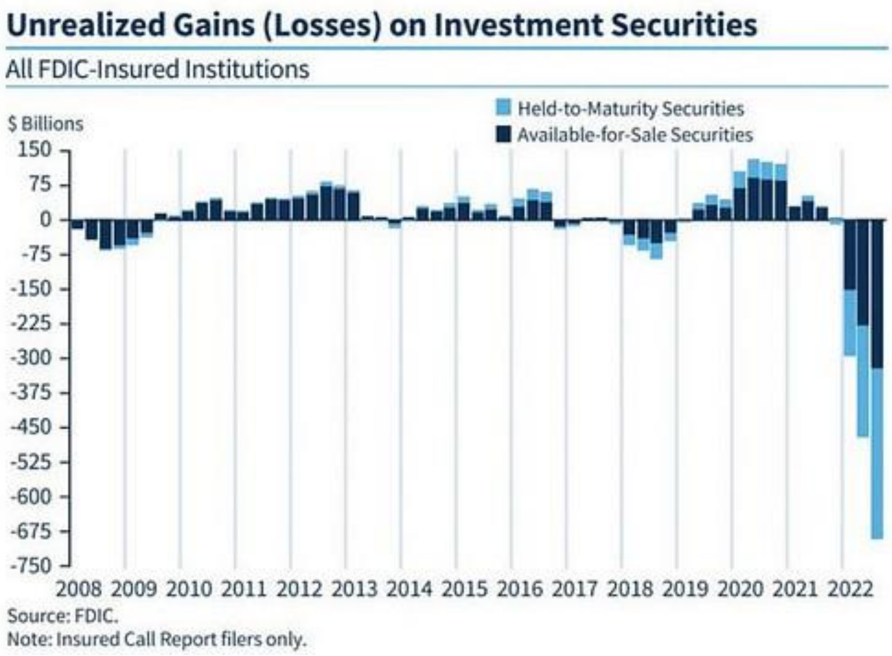
I spent many years of my banking career working on Asset Liability Management (ALM). Even 30 or more years ago, we measured and managed balance sheet interest rate exposure within strict limits and reported every month to the bank's ALTCO (Asset, Liability and Trading Committee). This was not only for Treasury trading books but the entire bank balance sheet.

So it's gobsmacking to hear how **Silicon Valley Bank** collapsed. It is a serious failure of bank management and regulator duty. SVB accepted billions in deposits from its tech customers, who were loaded with cash from equity raisings but who did not need debt. Instead of matching maturities of assets and liabilities, SVB decided to improve the margin by a modest amount by buying long-term US government bonds and mortgage securities without hedging (which would have made the exercise pointless anyway).

As interest rates rose beyond expectations, the mark-to-market losses ran into billions, but they may have survived if they were not forced to sell. As soon as a few leading VC firms started telling their companies to take deposits out of SVB, social media drove a frenzy, and the bank needed money to pay withdrawals. Only 7% of their deposits were FDIC-insured, increasing the panic in the tech sector, which had parked much of its cash in this one bank. Another example of poor risk management. Then the market realised that many more banks might be holding bonds with massive unrealised losses, and more panic followed, sending two other banks down. Bank unrealised losses shown in the chart below are over $A1 trillion.



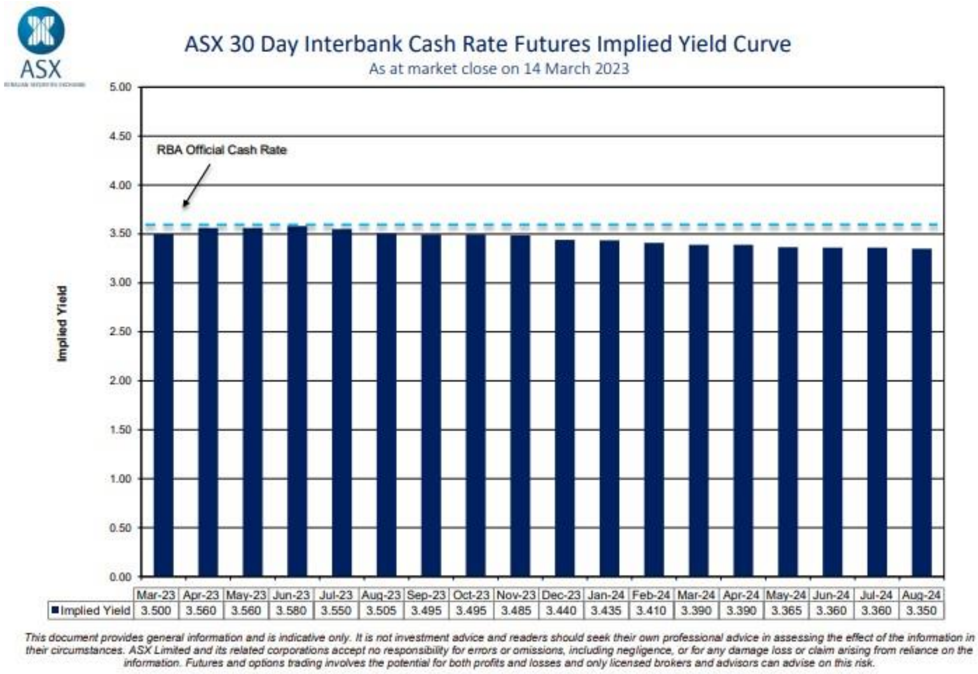
Crazy numbers. SBV had a US$200 billion balance sheet with US$120 billion in long-dated securities. This was not a credit problem, as their purchases were supposed to be the safest of investments. It was a maturity mismatch without hedging. There are nearly 5,000 US banks and failures are not uncommon, with 513 since 2009.

There seems little risk for depositors in Australian banks. Not only is regulation here much stricter, the banks are better managed. The Financial Claims Scheme (FCS) protects deposits in banks, building societies and credit unions (or authorised deposit-taking institutions or ADIs). The scheme covers deposits of up to

$250,000 per account holder per ADI. For example, a family may access $1 million of protection at the same ADI by investing in the name of a husband, wife, SMSF and company. Or more by spreading across many ADIs. But the [FCS only covers the first $250,000] for a fund that has invested $100 million with one bank, even if that investment is on behalf of 1,000 unitholders.

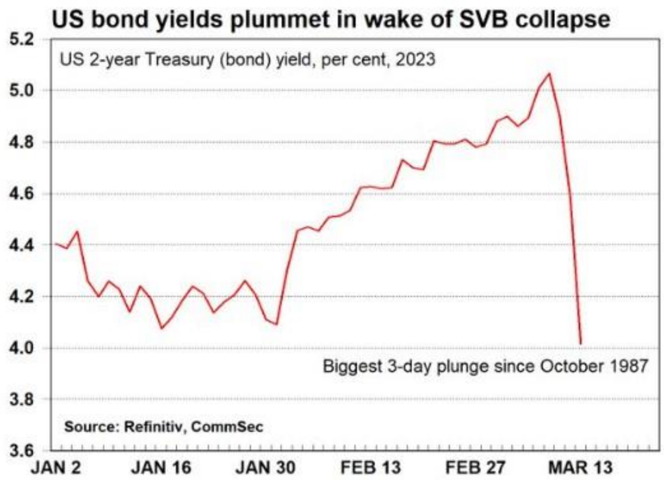
The main implication of SVB is on rate expectations both here and in the US. At end of February 2023, barely two weeks ago, the futures market was pricing cash at 4.35% by October. Not only has the cash rate moved up to 3.6% since then, but the futures market is now down to 3.5% by August and across all future maturities. Due to a perception that central banks will feel too much stress has been placed on banks and other borrowers, the market now thinks the next movement may be down. While the likelihood of a pause has significantly increased, the loss of a relatively-small, poorly-managed US bank should not cause a dramatic policy swing in Governor **Philip Lowe**'s thinking.

In the chart of cash futures below, all the bars from June 2023 onwards were well **above** 4% at the end of February, and now they are all **below** the cash rate of 3.6%. It's an extraordinary change due to the collapse of a US bank few of us had heard of a week ago.



The three-year bond rate in Australia is now about 3.05% and has been below 3% this week, at a time when cash rate is 3.6%. For the sake of hundreds of thousands of borrowers coming off 2% fixed rates in coming months, let's hope the market is right this time.

In the US, the two-year bond rate fell 0.58% in a day, driven by rate expectations relating to SBV.



Again, the **Federal Reserve** and other central banks will step in and rescue bad banking practices. The Fed has guaranteed all SVB deposits to avoid a run on banks overexposed to uninsured deposits. The implication is that the Fed may now be caught guaranteeing all deposits of any size fo all banks. Quite a change.

Many of the tech entrepreneurs who placed company cash with SVB are wildly rich beyond their dreams, enjoying all the trappings of a free enterprise system and plenty of VC cash. Yet with the first whiff of a banking problem, they rush to the regulators for help. The expression '*privatising profits and socialising* *losses'* comes to mind when the AFR reports that a group of 250 tech founders wrote to **Jeremy Hunt**, the **British Chancellor of the Exchequer**, requesting urgent help.

"The recent news about SVB going into insolvency represents an existential threat to the UK tech sector. This weekend, the majority of us as tech founders are running numbers to see if we are potentially technically insolvent. Most businesses are operating on very fine margins in the current economy and the contagion from the initial insolvencies will be vast and impact the economy far beyond the tech sector."

Sob. They might not be able to afford the second Ferrari.

A quick reminder to please fill in our Reader Survey. Every response helps us to understand ways to deliver a better newsletter for the next 500 editions.

Graham Hand

Also this week ...

While 2022 was a year of inflation, 2023 will centre on the economic cycle, according to **MFS CEO Michael Roberge**. And he thinks it's likely to feature a slowdown in growth. That should suit bonds and help the much-maligned 60/40 investment portfolio.

After three decades of phenomenal growth nationally, it seemed as though Australian house prices would never go down, until they did last year. Yet the downturn has been mild so far compared those of the past. **James Gruber** takes a look at previous property downturns and what we might learn from them.

Lastly, in this week's White Paper, **Franklin Templeton** *Fixed Income's ESG Engagement Report* highlights several key themes, including transparency being the bedrock of sustainable finance.

Curated by James Gruber and Leisa Bell

500 Editions of Firstlinks ... and counting

Graham Hand

To mark the 500th Edition of Firstlinks (including its predecessor, Cuffelinks), rather than an indulgent reminisce, we publish two extracts from other sources: Greg Bright's forthcoming book on the funds management industry, and Telum Media's recent interview with me.

Thanks for joining this 10-year journey with thousands of articles written by hundreds of expert contributors, in the fascinating and always-mysterious world of financial markets, investments and superannuation. These articles are stored in our searchable archive across a vast range of subjects and the search box is in the top right-hand corner of our home page. All 500 editions of Firstlinks are also stored on the website and accessible under 'Previous Editions' on the menu bar.

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Greg Bright is a doyen of Australian financial publishers, and over a four-decade career, he launched many of Australia's leading investment newsletters. Greg is working on a new book on the evolution of the superannuation and funds management industry in Australia, due for publication in early 2024, with the title: 'Our Money in Their Hands - the People Behind Super'.

His book will include a chapter on the specialist media which grew alongside the rest of the industry, and he has given permission to publish this extract. Nobody is better qualified than Greg to write the history of the industry, and it will be an passionate and informative read.

(I will add one thing Greg does not mention ... the Firstlinks newsletter usually enjoys industry-high open rates of around 60%)

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Covering SMSFs

While many have tried, few publishers have managed to appeal to the SMSF market from a specialist publishing perspective. Darin Tyson-Chan and Graham Hand are standouts.

Tyson-Chan went out on his own in 2012 and survived with his Benchmark Media through specialist publications and events. He became, probably, the most knowledgeable journalist focused specifically on SMSFs. While he has focused primarily on the industry sector supporting SMSFs, a more unlikely publisher, Graham Hand, has managed to attract readers among a swag of SMSF trustees themselves.

A former banker, including 12 years at Colonial First State, Hand didn’t set out to be a publisher in the SMSF market as such. In fact, he didn’t set out to be a commercial publisher at all. He decided on early retirement in 2012, when he had been General Manager of Funding and Alliances at Colonial First State, to concentrate on his writing. His first book, ‘Naked Among Cannibals’, was about banking, published in 2001, but his second, ‘Beyond Lucas Heights’, was a thriller backgrounded by Australia’s nuclear reactor, in 2005.

Having put fiction writing on the backburner for several years, he joined with former Colonial colleague Chris Cuffe to launch a weekly newsletter, Cuffelinks, in 2012. He always did the bulk of the work on the title and changed its name to Firstlinks when he acquired Chris’s share. He sold to Morningstar in 2019 but has remained at the helm as he attempts to manage himself back to more creative writing.

Firstlinks is an unlikely success story for several reasons. Graham wanted to publish quality information and views about investing, preferably without the constraints that advertising would place on the editorial. He also wanted to reach as many investors as possible, both inside and outside the industry. He and Chris were going to give something back to the industry which had treated them well, he said in 2012. As he has enjoyed pointing out since, we predicted that he wouldn’t last more than a couple of years. He would get sick of what would probably be more work than he expected for no money, we thought at Investor Strategy News. In 2023 he was still there.

Graham came up with a perfect way to be paid for his efforts, employ one or two staff to help and also stick to his guns on quality. Firstlinks has about two dozen annual sponsors; mainly fund managers which are listed on the newsletter and website and are able to have a limited number of edited versions of white papers and thought leadership pieces published in return. With Graham’s close direction, this editorial is a cut above the sponsored content found in the other trades.

The surprising thing is that well before it was sold to Morningstar, Firstlinks had developed a circulation which covered both the institutional and wholesale (adviser) parts of the industry as well as high-net-worth private investors (retail). The target was simply ‘engaged investors’. The free circulation of about 30,000 could be combined with Morningstar’s own mailing lists, totalling about 120,000. More importantly, his readers were more engaged than the average reader. This has resulted in a readership for Firstlinks of about 100,000 ‘monthly active users’.

With online publishing of investment industry news and information, the average reader cannot remember where they read what they read. It becomes an amorphous blur of mainly rehashed press releases published daily or intra-day. Even without hard news, or perhaps because of that, Firstlinks has stood clear of the blur, and readers seem to appreciate it.

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Telum Media provides news and information about media in the Asia Pacific region with dedicated country teams giving on-the-ground insights into the changing media environment. A weekly 'Telum Talks' is produced in Australia, including a recent interview with Graham.

Telum Talks To…Graham Hand, Editor of Firstlinks and Editorial Director of Morningstar Australia

by Chloe Arentz

As Editor of Firstlinks, can you give us a bit of background on the newsletter for someone who has never read it?

Firstlinks publishes enduring and original articles showing how to invest for the long term, rather than focusing on stories about today’s noise and market.

The weekly newsletter is free and our website includes thousands of articles on investing and financial markets. Most of our readers are not market professionals but self-directed, smart investors who want to learn more about their portfolios as they plan for the future. Each edition includes useful information for the full range of knowledge, from beginner to expert.

The newsletter is approaching its 500th edition. How has it evolved since its first publication?

We began over 10 years ago as a platform for experienced market experts, such as fund managers, to share their investing ideas. We have evolved into a leading site for discussing financial markets, investment products, retirement, superannuation, and demographics with engaged readers who comment enthusiastically.

Hundreds of people from a wide variety of backgrounds have written for us, all stored in a searchable archive. Although we write our own content, most of our articles come in each week from market experts who want to reach our 100,000 monthly active users.

What kind of story makes a good fit for Firstlinks?

We publish seven articles each week plus an editorial which gives scope to cover many topics and reader needs. Most of our readers are nearing or in retirement, and articles on superannuation and retirement planning always perform well.

We like fresh and original opinions, sometimes controversial, rather than simply facts, with evidence to support a view. The best engagement comes with articles discussing potential new government policies, and how to build a portfolio or asset allocations in changing conditions.

Considering the state of the global economy over the past few years, how do you think investment and superannuation strategies are changing?

In recent years, when interest rates were close to zero, it was difficult for investors or savers to achieve decent returns on cash or deposits, and many turned to the stock market for their income. However, older people generally do not have the risk appetite to hold most of their assets in shares and will tend to sell when the market falls.

The major change is that with rising rates, it is now possible to achieve around four per cent to six per cent on deposits or securities, which is sufficient income for many people. A diversified portfolio of stocks, bonds, property and alternatives will work well for most investors if they can focus long-term and not panic when the market falls.

Last time you spoke to Telum, you said the "media does investors a disservice with headlines like 'markets panic' and 'stocks plunge'." How has the financial media climate changed since then?

It has not changed, it is designed to sell newspapers or generate views. The hysteria turns people away from buying quality shares, which over the long run, are the best investments for generating wealth.

If investors can accept that the rewards from buying shares come with a degree of risk, and if they can ignore the noise and short-term volatility, they will be rewarded over the decades ahead to fund their retirement. Moving in and out of markets, buying at the top in euphoria and selling at the bottom in panic, delivers the worst outcome, and much of the media encourages these types of reactions.

Are there any big stories you are keeping an eye on this year?

There is always something happening in financial markets. The biggest story now is inflation causing rising interest rates, but much of the media coverage is repetitive and predictable.

The challenge is to find a different angle, as every news outlet is already describing how the Reserve Bank increases rates every month. It's become a boring story - a reporter standing in Martin Place, an interview with a home loan borrower, a quotation from the Reserve Bank Governor, dire consequences of future increases… it's the same each month.

Rather, focus on the implications for asset allocation, the winners and losers, and how investors should take advantage of the opportunities.

Also, the Federal Budget is coming in May and we expect major changes to superannuation, and the Government is undertaking a review of financial advice.

New eBook: the best part of my fund's investment process

Firstlinks

The next free eBook in our series marks the 500th Edition of Firstlinks

Fund manager investment processes vary widely, from the top-down to the bottom-up, the qualitative to the quantitative, the growth to the value, even the intuition and the finger-in-the-air. Price should always matter, as Warren Buffett said, "A too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favourable business developments."

We asked a group of about 30 fund managers we have dealt with for many years to consider their entire investment process and drill down into what drives the most success, asking:

"What part of your investment process has contributed most to identifying winners?"

Answers varied from the specific to the general with plenty of stock examples.

Thanks especially to the sponsors of Firstlinks who not only share their investing experience and knowledge in their articles, but enable free access to our newsletter and website for the circa 100,000 monthly active readers who make around two million pageviews a year.

Firstlinks continues to give priority to informing and educating ahead of clicks and advertorials, and thanks to all our readers for your interest.

Many thanks to Assistant Editor, Leisa Bell, for liaising with all the fund managers and producing this eBook full of different and insightful perspectives on managing money. Click on the book for a copy.

Our first Reader Survey for years to learn more about you

Firstlinks

While we have run recent Reader Surveys on specific topics, it is many years since we found out more about you and what you like and don't like about Firstlinks.

To mark our 500th edition, as your present to us, we would appreciate your feedback across a range of questions that will help to improve our content. It should take only a few minutes but provide great value to our future planning. The survey can be accessed via this link, or the QR code.

New tax gives incentive to move money out of super

Ashley Owen

At the end of February 2023, the Government announced plans to introduce a new tax on superannuation account balances above $3 million. This threshold will not to be indexed for inflation, so it will impact more savers every year through bracket creep alone. Inflation is likely to remain above target for many years and inflation has historically been the largest component of share prices gains in Australia. However, there is an even more important impact of inflation with this tax, as we outline below.

Taxing unrealised capital gains is a profound change

This new tax captures unrealised gains from any rises in the value of shares or property or other assets every year, even if they are not sold. It is an extraordinary departure from the existing tax system in Australia. People with super balances above the threshold will be better off holding the same assets outside super, paying tax at the top personal marginal tax rate of 47%, than leaving them in super paying the new tax.

How can this be correct?

The reason is that the current tax regime in Australia only taxes capital gains when they are realised, that is, sold for more than the cost base. But under this new tax, a return ('Earnings') is defined as any increase in the super fund balances from the start to the end of each year (after adjusting for contributions in and payments out).

As most of the gains from shares and real estate are from inflation, fund members will pay tax every year due simply to rising prices. Governments create inflation by printing money and deficit spending, and now a tax on assets in super will arise from the resultant price inflation. Inflation is already a tax on the purchasing power of money but paying this tax will further erode purchasing power.

For assets with publicly-available prices (shares, managed funds, LICs, listed bonds, etc), the unrealised gains will be easy to track and tax each year. The ATO has kindly offered to do this. For unlisted assets like direct real estate, private assets and collectables, valuations will depend on the frequency, the basis and the valuer involved. Where an unlisted asset (like a property) is the main asset, a member may need to sell the asset if they can't come up with cash from other sources to pay the tax every year.

Marginal personal rates versus the new tax

Let's return to the issue of how holding assets outside super and paying tax at the top personal marginal tax rate of 47% can incur **less** tax than holding the same assets in the new superannuation regime (taxable income at 15% plus 'Earnings' at 15% including unrealised gains).

Australian shares are the most common asset class in most super funds. Since the start of 2000, the broad Australian share market has generated total returns (ie share prices gains plus dividends) averaging 7.9% pa excluding franking credits and a grossed-up total return of 9.3% pa including franking credits for Australian shareholders.

Where did these returns come from? Nearly half (4.3% pa) came from dividends, nearly one third (2.8% pa) was CPI-inflation lifting share prices, one sixth (1.4% pa) was from franking credits, and less than one tenth of the total returns (0.9% pa) was from real growth in share prices above inflation. It is important to break down the returns into these components because each component has different tax implications.

While these were the average nominal total returns, the after-tax return varies in the hands of different types of entities. We look at four ways of holding the same basket of shares:

A. Pension accounts

Currently, super accounts in pension phase are effectively tax-free. However, because of the tax benefit of franking credits which refunds the taxes that the dividend-paying companies already paid on their profits, the after-tax total return was 9.3% pa, which is higher than the 7.9% pre-tax return. This amounts to an effective tax rate of minus 18% on the original 7.9% nominal total return from the share market since 2000 (the negative tax rate is due to the impact of franking credits).

B. Accumulation accounts

Currently, super accounts in accumulation phase pay 15% tax and realised gains are taxed at 15% (less 33% discount for sold assets that were held for more than 12 months). Assuming 10% portfolio turnover each year, taxes reduce the after-tax return to 8.5% (For this estimate, we need to assume some portfolio turnover as it creates taxable capital gains. Such turnover occurs even in relatively passive long-term funds.) This equates to an effective tax rate of minus 6% on the original 7.9% nominal total return.

C. Personal (non-super) accounts

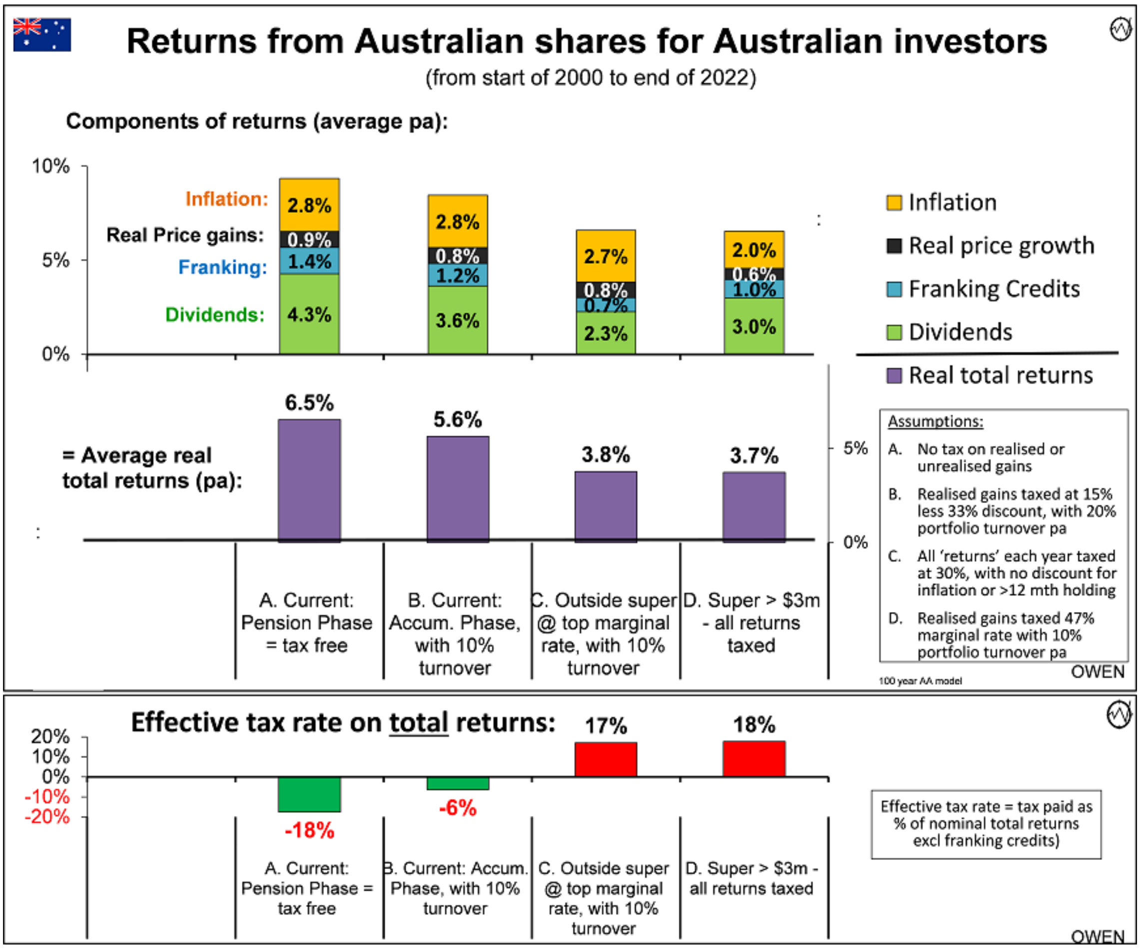
An individual holding the same portfolio outside super and paying tax at the top personal marginal tax rate pays 47% tax on dividends and franking credits and realised gains are also taxed at 47% (less a 50% discount for sold assets that were held for more than 12 months). Again assuming a 10% portfolio turnover each year, taxes reduce the after-tax return to 6.6%. This equates to an effective tax rate of 17%, which is a lower overall tax rate than the new 30% super tax.

D. Super above the new threshold

Super accounts above the new threshold will incur an additional tax, the existing 15% plus 15% on the balance above $3 million, with the expanded definition of 'Earnings' applied. There is no discount for inflation or assets held more than 12 months. Despite the 15% plus 15% headline tax rates, the effective tax rate is actually 18% due to the impact of franking credits.

[Note that D applies to investors in the top marginal tax rate. However for people in lower tax brackets, the position is even more favourable outside super as they can earn up to $170,000 pa before their average tax rate is more than 30%, and importantly, taxable income outside super does not include unrealised gains.]

This chart shows the components of returns from the broad Australian share market from 2000 to 2022, and also shows the effective tax rates in the four tax scenarios:



The set of purple bars in the middle show the average after-tax real (ie after inflation) total returns for each entity. This the most important number for building long-term portfolios that aim to generate cashflows that keep rising for inflation, and also keep the capital base (after withdrawals) rising so that future incomes also grow for inflation. Retirement funds need to generate at least CPI+4% and most of this comes from shares. We can see here that this is not achieved in scenarios C and D.

It is similar with other types of long-term assets. Foreign shares are even more favourable outside of super when the new tax hits because less of the total return pie comes from dividends and more comes from capital gains.

Impact of eventual sale and realising capital gains

It is true that, if or when the asset is eventually sold, capital gains tax would be paid at that time, but there would be several benefits of doing this outside of super:

- the tax on the increase in capital value would be deferred until the eventual sale, instead of being taxed each year of unrealised capital growth.
- the capital gains tax would be reduced by the 50% discount on sold assets held for more than one year.
- the sale could be done at a time when the owner s marginal tax bracket is much lower (eg in retirement), reducing the tax further.

- Holding inside super may result in having to sell other assets to pay the yearly tax on unrealised gains, but if holding outside of super, you only pay tax when you have the cash from the eventual sale.

The new tax punishes investments that rely on capital gains

As most of the gains from long-term investment assets come from long-term value gains (most of which is simply inflation), rather than cashflows (rent, dividends, etc), this new super tax amounts to a heavy tax on long-term investment. But savings is the source of capital for investment, which creates jobs, funds innovation, which is the source of increased productivity and living standards for the whole nation.

This is only draft legislation at this stage, although it does spell out the plan to tax unrealised gains for the first time, with worked examples to show how it will operate. Once the broader implications are fully understood, it will struggle in parliament. If it gets through, it is likely to add complexity. This, and other mooted plans for super, like commandeering super funds to invest in government agendas like renewables and social housing (however well-intentioned), would appear depart further from the goal of simplifying super.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual, and is based on an understanding of the current proposal to change the way large balances in superannuation are taxed.

Most people (and the ATO) do not know their super tax

Graham Hand

***"Make everything as simple as possible, but not simpler."* - Albert Einstein**

When the Government decided people with high superannuation balances were receiving overly-generous tax concessions, it needed a method to identify the culprits. Intuitively, the obvious approach was to introduce a third tax tier: superannuation is already taxed at 15% in accumulation mode and 0% in pension mode. Here was a new tax rate on large amounts, so let's call it 30% on the balance in excess of $3 million. And so the announcement was made:

"From 2025-26, the concessional tax rate applied to future earnings for balances above $3 million will be 30%."

It was not until the following day that a Fact Sheet was produced, and the head scratching started. To everyone's surprise, it was a new 15% tax on a completely different base which included unrealised capital gains in the calculation. Treasury had realised it needed a solution to cover 23.3 million super accounts, of which only 1.1 million were in SMSFs.

Type of fund	Total assets ($billion)	No. of funds	No. of accts (June 2022)
Corporate	56	12	0.2 million
Industry	1,081	28	12.4 million
Public sector	634	32	3.0 million
Retail	633	82	6.6 million
Funds with less than 7 members	865	604,825	1.1 million
Balance of statutory funds	51		
Total	**3,322**		**23.3 million**

Source: APRA Statistics – Sep quarter 2022

Source: ASFA

A new tax definition of 'Earnings', not taxable income

Based on many of the hundreds of comments in Firstlinks, there is confusion around why Treasury and Treasurer Jim Chalmers chose the change in Total Superannuation Balances (TSB) for the tax. A tax invoice will be sent to large holders of super based on a new concept of '**Earnings**':

*Tax Liability = 15% x **Earnings** x Proportion of Earnings over $3 million*

'Earnings' includes the change in TSB over a financial year. TSB is the total amount an individual holds in super, based on revalued assets.

Why did Treasury choose this tax method?

Channelling Albert Einstein (assuming the above quotation is accurately attributed to him), the Government wanted to make the calculation simple, but have they made it simpler than necessary and introduced flaws?

When Jim Chalmers instructed Treasury on his new revenue intentions, someone in the office knew there would be a problem in simply adding a third tier, which is why the announcement said:

" … the Government's implementation approach seeks to avoid imposing significant (and potentially costly) systems and reporting changes that could indirectly affect other members. The proposed approach is based on existing fund reporting requirements. Noting that funds do not currently report (or generally calculate) taxable earnings at an individual member level, the calculation uses an alternative method for identifying taxable earnings for members with balances over $3 million."

Treasury needed to rely on the data held by the Australian Taxation Office (ATO) which knows the TSB, contributions and withdrawals across all super funds. It does not hold individual super tax information nor the taxable income of members of retail and industry funds.

In fact, nobody holds a consolidated view of taxable income.

Tax is not paid at the individual member level by large funds, in contrast to an SMSF where a member's tax position could be identified. But any new tax needs to accommodate all forms of super, not only SMSFs.

In the spirit of keeping explanations simple, rather than going into the weeds and actuarial intricacies of large fund accounting, here's how tax works.

The unit price for any fund is calculated by dividing the net asset value of its investments by the number of units on issue. The net asset value is the value of all assets, less fees, expenses and tax. Tax is paid in a large fund as an adjustment to the unit price.

Pension or accumulation funds are separate legal entities which hold units (investments) in a 'wholesale' fund, with the impact of revaluations and taxation calculated at a pooled level. The unit price in the accumulation fund is adjusted for taxation at 15% and pension fund at 0% based on income, realised capital gains, franking credits and withholding taxes. A fund member only sees the impact in the unit price which may be $1.50 instead of $1.60, but there is no way to isolate the individual tax impost based on current systems.

The large fund does not know which of its members should pay an additional tax because it does not know the member TSB. A member may hold super in a dozen different accounts. The only way to adjust the unit price is when all members pay the same tax rate of 15% for accumulation and 0% for pension.

Treasurer Jim Chalmers is stuck with a calculation method and now justifies taxing unrealised capital gains by saying it was Treasury who advised him to adopt this method.

"That's the advice of Treasury, working with other relevant agencies, that that is the most efficient, simplest and best way to go about it, and so that's what we intend to do."

How accurate are the asset valuations?

It is not only the taxing of unrealised gains which is driving the call to reconsider the policy. It brings into sharper focus the issue of how unlisted assets are revalued. Previously, this valuation debate centred on the impact on unit prices for performance purposes, such as whether favourable valuations allowed large super funds to produce good results in the Your Future Your Super test.

Performance tables frequently include funds which hold large portfolios of unlisted assets which have not been revalued down in the face of rising interest rates in the same way listed funds are forced to recognise a market value. A prime example is in the listed property space, where property trusts are trading on listed markets at large discounts to their NTA values, while the assets have retained their value in the unlisted space.

This is a complicated and emotive subject for another place, but the added complication with this new tax is that members will now pay tax on the values of thier super assets, intensifying the focus on how assets are valued.

Problems will also arise in the listed space, such as on illiquid securities. Small and mid cap stocks notoriously trade in small volumes and prices can vary widely depending on whether a bid or offer is hit at the last trade.

Will large super holders consider other options?

SMSFs are set up for many reasons, such as control over a wider range of investments than offered by large funds. However, the imposition of a new tax will encourage trustees to consider alternatives. At least two come into play: other tax structures and holding assets in personal names.

1. As another article by Ashley Owen demonstrates, based on assumptions on how much unrealised capital gains are likely to be taxed, an investor with a personal marginal tax rate of 47% (but excluding unrealised capital gains) may pay less tax than an investor in superannuation with the additional 15% (but with tax levied on unrealised gains).

2. Other tax-related strategies will receive a boost, such as:

- Where a Condition of Release has occurred, cash out the amount in excess of $3 million.
- Move the money into a Discretionary Family Trust (DFT) which includes a company as a beneficiary.
- Pay the income from the DFT to the company beneficiary which pays tax at 30% (or to any family member with a marginal tax rate rare below 30%)

The impact of this change is that tax is still paid at 30% but only on realised gains. It also removes the risk of paying the 17% tax on death when super is not paid to a dependant. Treasury should expect a big increase in the use of DFTs and less tax on unrealised gains and death benefits, and these should be factored into the so-called $2 billion a year in tax savings.

Already legislated but not certain are the Stage 3 tax cuts, offering a flat marginal tax rate of 30% between $45,001 and $200,000. This change will push even more people out of superannuation.

How would a deeming rate work?

Treasury was effectively given two choices: create a simple method to calculate a new tax, as adopted, or invent a new process, such as a deemed return on large balances.

A deeming rate is used in social security to assume an earning rate on assets for pension eligibility, and there is a General Interest Charge (GIC) on unpaid tax liabilities. In super, a rate could be applied to large balances and taxed accordingly.

There is an obvious flaw in this alternative which probably discouraged its adoption. In the market falls and the TSB reduces and unrealised capital losses result, a large super holder would still receive a tax bill, unlike in the proposed scheme.

Is a systems change really so difficult?

Treasury and the Treasurer went for a simple method to impose a new tax, based on ATO records. If implemented, it will create large tax bills in years when stockmarkets, property or other asset revaluations deliver strong returns.

The large super funds have strongly resisted a major change to their systems to identify individuals with over $3 million, and funds do not want the added burden of further tax collection. On the surface, it does not seem an insurmountable systems problem to identify the pre-tax income of each person in a super fund and advise the ATO, which can combine the data with the super balances and impose a new tax on those above $3 million.

For the moment, due to the lack of consolidated taxable income data for super, Treasury has created a new tax with far-reaching consequences it did not expect.

Graham Hand is Editor-at-Large for Firstlinks. This article is general information based on an understanding of the current new super tax proposal which has not yet been legislated.

The 60/40 portfolio is back

Michael Roberge

2022 was a year of inflation. Most central banks were behind the curve and had to tighten aggressively to catch up. In 2023, I think focus will be more centred around the economic cycle. Inflation is slowly coming down. The question now becomes will we have a recession? Soft landing or hard? In a year, the narrative will be around the extent of the slowdown in economic growth and what the next economic cycle might look like.

What the yield curve may be signalling

The federal funds are now at about 4.5 to 4.75%, and the market is pricing in a terminal rate around 5.25% to 5.5%, signalling a couple more hikes.[1] The US Federal Reserve controls the short end of the curve. While three-month rates are a little higher, the market controls the ten-year rates, which are around 3.69%.[1] The curve is significantly inverted. Historically, when the yield curve inverts like this, the economy slows significantly or goes into recession. Yet, the markets are anticipating that the Fed will ease in the second half of the year. While inflation is set to come down in 2023, I think it will stay higher in the first half than central banks are comfortable with, and as a result, policy rates will likely stay higher for longer.

The case for active

Many recessionary signals are flashing, yet risk assets don't seem to agree. Looking at Wall Street consensus earnings, expectations, while down 2% to 5%, are not consistent with a typical recession, which would be down 10% to 30% plus.[2] In a traditional cycle, equity markets don't usually bottom until earnings bottom. Companies are suggesting that they can protect margins even though the economy will likely slow.

Yet, I don't think companies know what growth will look like, and looking forward, I don't believe that earnings have bottomed. This cycle will be different from the last, leading to an environment where active management matters. Decades of declining interest rates have acted as a tailwind for earnings and profits. Labor as a share of gross domestic product (GDP) came down and capital expenditures fell dramatically. These factors contributed to higher margins, which are still near all-time highs.

The backdrop of the last 10 to 12 years has reversed. As mentioned above, inflation will be higher, and central banks will not be able to bring rates down as expected. In response to lessons learned during COVID, companies are onshoring supply chains which will create additional costs. Following the global financial crisis, capital expenditure (capex) went to dividends, share buybacks and non-tangible assets.[3] Today, capital intensity has already gone up for many businesses as they invest in plants and equipment. Reducing carbon intensity also means more capital being put to work. (The great thing about capex is that it potentially produces growth over time, and you can get a return on that.)

Labor costs are rising as companies retain and hire employees. Investments in labor diversity and equality should lead to better growth and make the world a better place, yet that may come at the expense of margins. For those reasons, I think the cost environment for companies is going to be very different, and peak multiples and margins are in the rearview mirror, not ahead of us. Again, this is an environment where active management matters — identifying companies with strong competitive positions, pricing power and cash flows that can provide some protection for earnings.

Volatility and dispersion: Opportunity for active managers

We have come from an environment where central banks took rates to zero and suppressed volatility. Every time something bad happened, the Fed stepped in and provided liquidity. We're no longer in that environment; we're in one where volatility will be higher, which creates massive opportunity for dispersion and active managers. The era of cheap beta in passive management, I think, is behind us.[4] Differentiation matters and having an edge from a time horizon perspective makes a difference. Today, we are overloaded with information, but we're starved of knowledge. The ability to tune out the short-term noise and identify the things that drive long-term value is an advantage in the marketplace today.

The market is shifting once more toward valuing a business based on its cash flows. Looking back, a significant number of small-cap companies — zombie companies — didn't produce enough operating cash flow to pay their debt off. That capacity should have been removed from the system, allowing healthier companies to have pricing power. Those are the companies that should win. That's what active managers can do; try to identify and invest in them to seek risk- adjusted returns for clients.

Asset allocation: 60/40 is back

Over the past few years, people have wondered if the 60% equity/40% bond portfolio was dead? Looking forward, I think 60/40 is back. From an investment perspective, this environment is far better than the past decade. Cash has a return. Fixed income markets have an attractive return, even after adjusting for inflation. You can assess risk premiums on those rates now and build an asset allocation that makes sense over time. That wasn't the case when rates were near zero and volatility was low.

Today, I think investment-grade corporate bonds make sense. You're getting an attractive yield with a reasonable spread for the credit risk, possibly providing a reasonable through cycle return. While equities and some of the riskier fixed income markets may have some challenges, a solid risk-free rate (Treasury rate) added to a 3% to 4% equity risk premium is a good through cycle return. We're not smart enough to call the bottom; if equities underperform for part of this year as earnings come down, I think rebalancing back to a 60/40 allocation or other proper allocation makes sense for investors. Opportunities are there for investors today, which was not the case a couple of years ago.

Michael W. Roberge is chair and chief executive officer of [MFS Investment Management](). This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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Endnotes

[1] Bloomberg and US Federal Reserve as of March 14, 2023.
[2] FactSet Research based on constituents of the S&P 500.
[3] Capital expenditure or capex is the money an organization or corporate entity spends to buy, maintain or improve its fixed assets, such as buildings, equipment or land.
[4] Beta is a measure of the volatility of a portfolio relative to the overall market. A beta less than 1.0 indicates lower risk than the market; a beta greater than 1.0 indicates higher risk than the market. It is most reliable as a risk measure when the return fluctuations of the portfolio are highly correlated with the return fluctuations of the index chosen to represent the market.

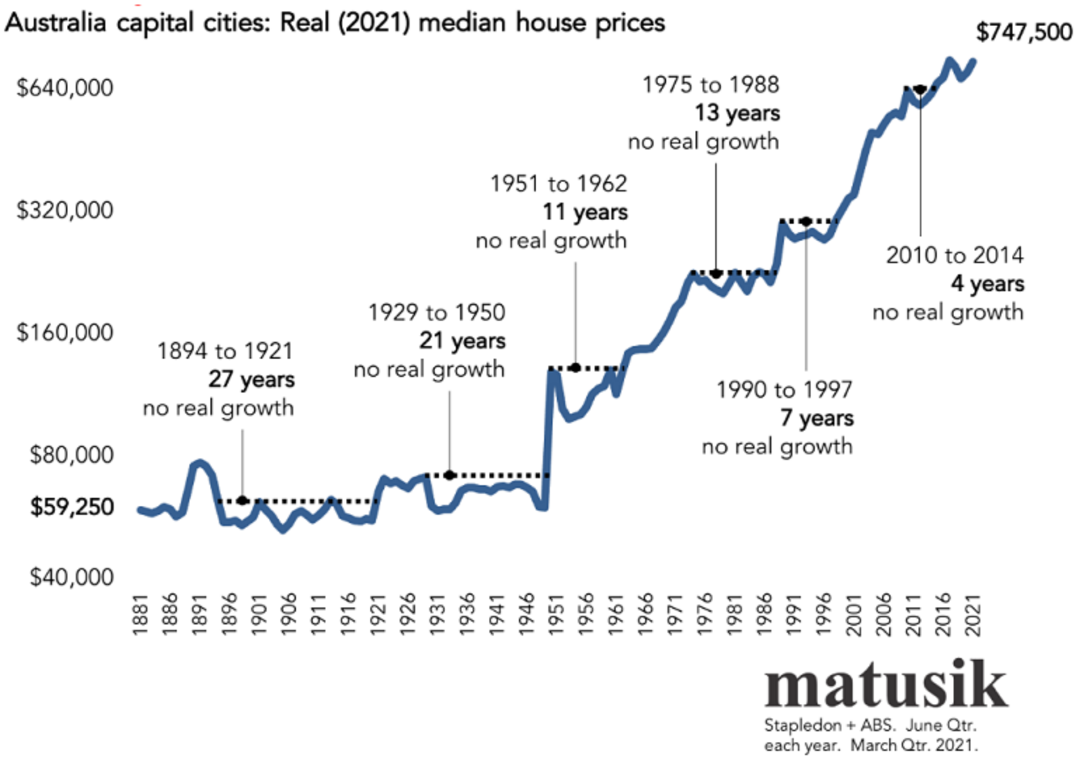
Lessons from Australia's largest property busts

James Gruber

Australians believed house prices would never go down, until they did last year. Yet the downturn has been mild so far compared with those of the past. For instance, Melbourne house prices went down 51% in real terms (prices minus inflation) in the 1890s. Real prices nationally were flat for 60 years until 1950. Prices went down more than 20% in key cities during the 1980s.

History shows the housing market has been a story of boom and bust. Today, we look at previous downturns: what caused them, how they played out and what we can learn from them.

As Mark Twain once said, *"History never repeats itself, but it does often rhyme."*



The 1890s collapse

The 1890s witnessed Australia's worst ever house price decline. Not only did Melbourne's prices fall more than 50% in real terms, but Sydney's also fell 36%. House prices then went nowhere for 60 years. In other words, an adult at that time often didn't see a time when property was a good investment.

The boom which preceded the bust was as equally spectacular. It started in the 1850s and 1860s with the gold rush. And the mining boom continued into the 1880s and gave birth to the likes of BHP – originally named The Broken Hill Proprietary Company, operating a silver and lead mine in Broken Hill – and Rio Tinto – which was established overseas.

The mining upturn was accompanied by a flourishing agricultural sector, especially the rapid growth of the wool sector.

The economic opportunities from the boom attracted a large inflow of immigrants. Australia's population went up 8x from 400,000 to 3.2 million. Melbourne population grew 16x from 30,000 in 1851 to 485,000 in 1890, or 7.5% per annum!

Unsurprisingly, housing demand took off during the period and prices moved up sharply. A house construction and lending boom soon followed. Yet by 1885, there was a housing surplus, and the market started to falter. Construction reaccelerated once more before falling and 1889 marked the peak in prices.

Banks helped propel the property upturn. The 1870s and 1880s also witnessed the proliferation of non-bank institutions such as building societies, which weren't shy about lending freely to property developers.

Overseas investors becoming concerned about their Australian investments. A crisis at Barings Bank in London in 1890, although focused on Argentina, led to a reassessment of Australian holdings and withdrawal of funds.

This, and the property crash, caused a banking crisis. The Bank of Van Diemen's Land was the first major bank to fail in 1891, and 13 others followed. Consequently, the eastern colonies suffered a severe economic depression in 1890-1891.

World War One

The next property downturn was milder and briefer. In real terms, prices fell but not by much. World War One impacted both the supply and demand for housing. Demand was hit by soldiers going off to fight in the war as well as a slowdown in immigration. Also, investor demand fell as rents went down, partly due to government measures to protect soldiers from any increase in rents. Because demand fell, supply cuts followed.

Prices and rents didn't really pick up until 1920 as Australia worked through the devastation wrought by the war. Immigration started to increase again and unbeknown to people at the time, it was to be the start of the 1920s economic boom.

The Great Depression

The boom centred around agriculture. Wool had been Australia's primary export to this point, but new goods such as wheat, dairy, and other produce were introduced. Soldiers returning from the war were resettled on farms and more than 200,000 government-sponsored British immigrants arrived, many heading to country towns.

As European countries started to recover from the war, the US, Argentina, and Canada saw the opportunity for increased agricultural demand. This led to a global oversupply in two of Australia's major exports: wheat and sheep.

Meanwhile, federal and state governments were borrowing freely from overseas institutions throughout the 1920s. They used the money on major public infrastructure works. But, when commodity prices started to decline in 1927, the overseas money dried up.

As commodities dipped and overseas economies and stock markets tanked in 1929, Australia experienced its largest-ever economic decline. Income dropped by a third and unemployment peaked at 32% in 1932.

Housing during the Great Depression fared much better than the 1890s. Yes, nominal prices fell more than 25% from peak levels but due to the substantial deflation at that time, real price declines were far less. From the highs of 1929, Sydney and Melbourne property prices fell 11% and 13% in real terms to their respective lows in 1932 and 1931 (compared with the 36% and 51% falls of the 1890s) and they recovered most of those declines by 1939.

The reasons why housing didn't fall further were three-fold:

1. The prior boom of the 1920s was relatively mild.
2. Rents didn't decrease as heavily as in the 1890s.
3. Bank balance sheets were in better shape.

World War Two

Governments introduced house and rental price controls in 1942. With significant inflation due to the war, it left property prices at ludicrously low levels by the time price controls were lifted in 1949. And when the controls were removed, prices went gangbusters. In Sydney, they went up 77% in about 12 months.

Prices peaked in real terms in 1950 and then fell by 25% by 1953. The main reason for the drop was the preceding overshoot in prices when price controls were lifted.

Interestingly, the lifting of price controls coincided with a transformation in the structure of the housing market. The rental share of houses in capital cities declined from 55% of the market in 1947, to 20% in 1961. This can be attributed to recovery from the Second World War, a huge influx of immigrants from Europe, a surge in economic growth in the 1950s and the major infrastructure projects initiated by Labor governments after the war.

It was during this period that the 'Australian dream' of owning a home took shape.

The 1974 downturn

The property boom of the 1960s and early 70s was the result of many factors:

- The natural economic upswing that took place after World War Two not only in Australia but overseas.
- The mining boom during the 1960s.
- The large population increase through increased immigration.
- Higher density developments to cater for more people.
- The expansion of cities and infrastructure to help house more people.
- The increasing sophistication of capital markets and the beginnings of Sydney as an international financial centre.
- The housing boom was aided by a lending boom. Banks and non-banks joined in the party.

By 1974, Sydney residential prices were up 116% from their 1950 peak in real terms while Melbourne's was up 47%. Sydney fared better due primarily to a sharp increase in fringe land prices.

From their peaks, Sydney and Melbourne prices fell 18% and 24% respectively in real terms. Whereas real price falls in the 1890s and 1930s translated into nominal price falls, the high inflation that epitomised the 1970s cushioned the fall for the property market and protected the banking system.

Yet, property prices didn't reach 1974 levels in real terms until 1988, 14 years later.

The 1990s recession we had to have

The seeds of the 1990s housing downturn were multifaceted. The early 80s brought a mini-mining boom that turned into an entrepreneurial boom, with colourful personalities including John Spalvins, Robert Holmes a Court, Alan Bond, John Elliott, and Christopher Skase splurging money lent by deregulated banks.

This was against a backdrop of significant economic reform from the then Labor government, including the floating of the Australian dollar, removal of limits on the interest rates that could be paid on deposits and charged for loans, and introduction of competition from foreign banks.

The increase in access to credit led to a late 1980s construction and lending boom which turned into a bad bank debt crisis in 1990-1991. Many banks collapsed including the State Bank of Victoria, the State Bank of South Australia, the Teachers Credit Union of Western Australia, and the Pyramid Building Society in Victoria.

During the recession, GDP fell by 1.7% and the unemployment rate rose to 10.8%.

Despite this, the downturn in residential housing was mild. From peak to trough, prices decreased nationally by just 8% in real terms. The Melbourne's market fared worse, with a drop of 19%, thanks to a string of banking failures and subsequent job losses.

It was the commercial property market that suffered more. For instance, Sydney office prices declined 40%. It was problems in commercial property that led to banking troubles and recession.

The 2022-2023 bust

The causes for Australia's current downturn may be simpler than previous downturns. The Reserve Bank of Australia and other central banks kept interest rates at levels well below inflation rates for most of the past 20 years. Unsurprisingly, it fuelled booms in almost everything, including real estate.

In Australia, the housing upturn was helped by significant population growth pre-Covid, strong labour markets, and supply shortages driven by government costs/taxes/inaction.

In the three years to the end of 2021, median house prices surged by 43% in Sydney, Brisbane, and Canberra, 41% in Melbourne, and 62% in Hobart. The boom in house prices ended with the rate hikes in 2022. Even after price falls of 10% in 2022, nominal prices remain well above where they were before the boom began.

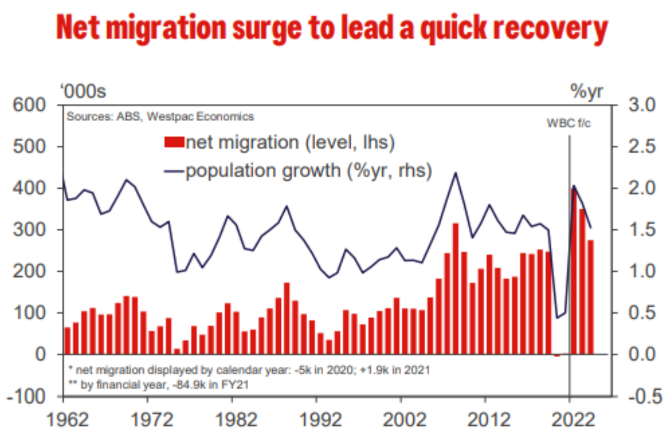
Where to from here?

If there's one lesson from history, it's that the larger the real estate boom, the larger the likely bust. Given the extraordinary house price rises that took place up to 2021, that's cause for concern.

Yet each period is different, and our current one has positive and negative features for the property outlook.

The positives:

High population growth and favourable demographics. Unlike many other Western countries, Australia enjoys strong population growth driven mainly by immigration. Net migration totalled more than 400,000 people last year, while this year another 350,000 is expected – both huge numbers. Our demographics are also favourable for the housing market with fewer people per household going forward.



Favourable tax treatment. Tax breaks include negative gearing on investment properties, exemptions from capital gains, and means tests on owner-occupied homes. These should remain in the short-term, though given the size of these tax breaks, governments will eventually have to trim them.

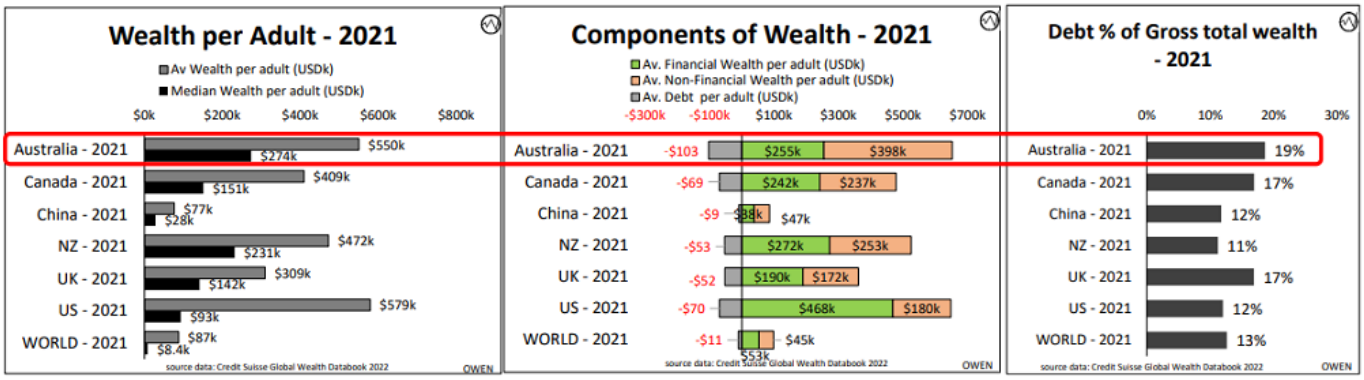
Supply constraints. Driven primarily by people who don't want further development in their neighbourhoods and the councils that pander to these residents.

The negatives:

High household debt. Australians are the wealthiest in the world, and 72% of that wealth is in housing. We're also the most indebted, in absolute and debt-to-asset terms. Mortgage monthly repayments has risen to 50% of income, a high number that's likely to squeeze many households.

City	Dwelling price-income ratio (x)	Monthly repayments (% of income)
Sydney	13.1	61.5
8 capital cities combined	10.5	49.4
Hobart	10.3	48.1
Brisbane	9.9	46.5
Melbourne	9.6	45.2
Adelaide	7.9	37.0
Perth	6.9	32.2
Darwin	5.1	23.8

Source: BARRENJOEY



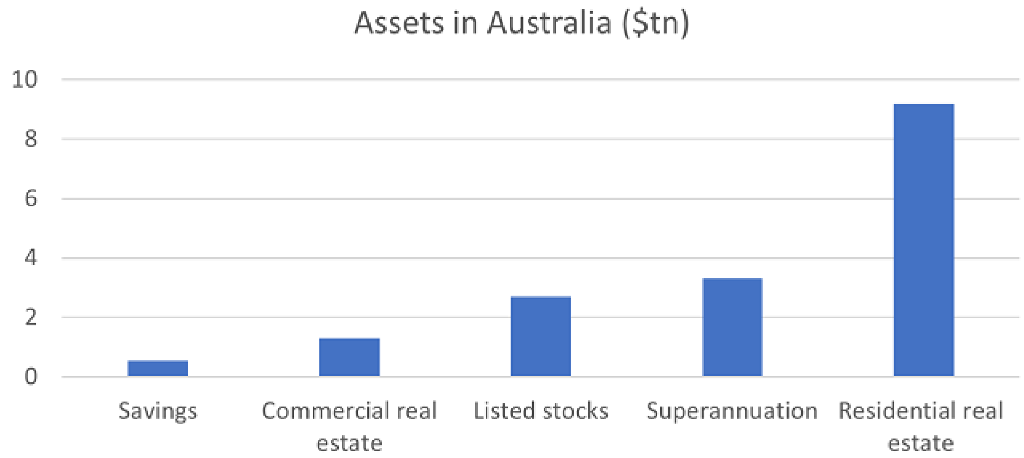
High percentage of variable rate debt. Unlike in the US where people are principally on fixed-rate loans, the bulk of loans in Australian are variable rate. That means any change in the cash rate immediately impacts people here. There's also close to 900,000 loans totalling $350 billion switching from fixed rate to variable rate this year, and that'll result in much higher rates for these loans.

The large number of investors who own residential property. Out of around 10.8 million residential homes, investors own 3.25 million, or about 30% of the total.

Exhibit 5: Fixed rate maturities accelerate noticeably in 2Q23

Source: RBA, Morgan Stanley Research

Residential property's size makes it too big to fail. The total value of residential property at $9.3 trillion dwarfs our annual GDP of $1.55 trillion. Crash housing and it'll crash the economy.



Source: Corelogic, Finder

Valuations. With 10-year government bond yields at 3.65% and mortgage rates close to 6%, current nationwide rental yields of 3% for houses and 4.5% for apartments look decidedly unattractive. For them to offer better value, rents will have to rise a lot, or prices will have to decline, or a combination of both.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

References: The history in this article has been sourced from the following: Nigel Stapleton's academic paper, 'A History of House Prices in Australia, 1880-2010', various monthly reports from Stanford Brown's Ashley Owen, and John Vander Have's UNSW graduate paper, 'The 1974 Collapse of the Property Market in Sydney', and Corelogic reports on the 2022 downturn.