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Weekly Review

WEALTH

– Issue – 11 Nov. 2016

The knee-jerk reaction to Donald Trump's election shows why investors must remain focused on their long-term goals.

BY TONY KAYE • EUREKA REPORT • 9 NOVEMBER 2016

Trump slump: Don't panic as markets fall

For savvy investors with available cash, the near 4 per cent slump in the Australian share market on Wednesday (November 9) was a definite opportunity to buy undervalued, quality stocks.

It was also an opportune time to reflect on the need to switch off from the day-to-day market noise and focus on your long-term game plan.

Global markets have been highly volatile for months, with the lead-up to the US election fanning investor uncertainty and sparking widespread selling. November 9 was a culmination of that uncertainty, of sorts, but expect the US and European markets to remain volatile.

Having opened the day higher, the Australian market went into freefall by the afternoon as US vote counting put Republican Donald Trump into an election-winning lead ahead of his arch Democrats rival Hillary Clinton.

It then rebounded later in the session, as strong buying activity helped blue-chip stocks to recover some of their losses.

Among the big losers on the day were the major banks and diversified miners – all already under earnings pressures – while a flight to safety saw some gold stocks rally more than 10 per cent in line with an almost $US50 spike in the gold price.

Click here to read our full market coverage.

For investors, the Australian market's current volatility in light of the US election result should not be a surprise.

"A Trump victory would likely trigger a further initial bout of "risk off" with shares down by 5 per cent or so (both in the US and globally) and safe havens like bonds and gold rallying as investors fret particularly about his protectionist trade policies triggering a global trade war," noted AMP Capital's chief economist, Shane Oliver, in his Eureka Report **column** last weekend.

"Australian shares would be particularly vulnerable to this given our high trade exposure (exports are 21 per cent of GDP in Australia against 13 per cent in the US)."

Dr Oliver added that a Trump victory could also mean that the US Fed will be less likely to hike official interest rates in December, while the Australian dollar would likely still suffer from the threat to trade and the initial "risk-off" environment.

"A Trump victory to the extent that it leads to falls in investment markets and worries about a global trade war may also increase the chance of another RBA rate cut in Australia," he said.

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Market nervousness is likely to be here for some time, but all investors should hold tight rather than get caught up in a mass panic attack.

If you are unsure about what to do next, join us at one of our InvestSMART events on Building a smarter portfolio.

It's not too late to attend our events in Brisbane (November 16), and Melbourne (November 24), to hear from our team of investment experts on the strategies you should be using. **Click here to register now.**

The price of gold went into overdrive on Wednesday, with the widely unexpected US election outcome spurring investors to buy the safe-haven pseudo currency.

BY TIM TREADGOLD • EUREKA REPORT • 10 NOVEMBER 2016

The next big gold rush

Gold loves a crisis, which is what investors thought they were seeing yesterday (November 9) with the election of Donald Trump as US President. Within 24 hours however, the supposed crisis had passed and the gold price had retreated – for now.

Key Point

- ***The question for investors is, has gold done its dash? For now, is probably the answer, but impending upheaval in Europe could soon spur another rally.***

In a remarkable five hours of panic buying the price of gold was lifted by $US61 an ounce (4.8 per cent) from $US1272/oz to $1333/oz, before retreating to exactly where it started; $US1272/oz.

Australian goldmining companies rallied even harder, with the ASX gold index rising by 9 per cent as leaders such as Newcrest added $2.75 (12 per cent) to $25.35 and Northern Star enjoyed the same percentage rise (12 per cent) as it put on 52c to $4.64.

Given the retreat in the gold price as the US election result is digested and Trump's bombastic election rhetoric tones down, it is likely that most of Wednesday's gains will be washed away.

If there was anyone who slept through the dramatic presidential election count they might now be imagining that the past 24 hours was a calm period on financial markets, with not much changing.

Obviously a lot did change, but precisely what will not be known for months, and in that time gold is in the front line of a series of events with the potential to be as dramatic as the election of Trump and Brexit – the June decision by Britain to quit the European Union.

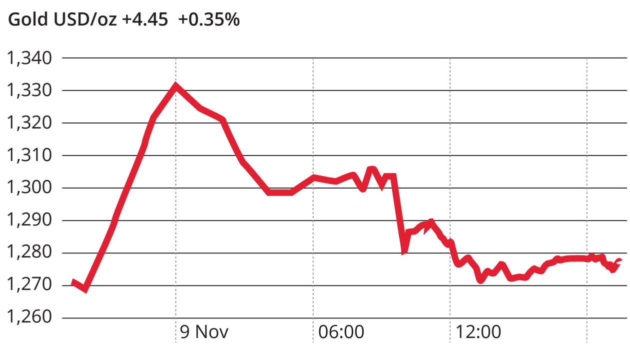
What's next for gold?

Politics, not logical financial-market investment decisions, are driving demand for gold, as they have in the past and will do in the future.

Europe, or more specifically the break-up of Europe, is the next possibility as a populist revolution rolls around the world in a dramatic aftershock of the 2008 global financial crisis, which enriched a handful of people but left millions poorer, and angry.

Brexit can now be clearly seen as the first shot in a war of ideas that is changing the way the world works. President-elect Trump is a bigger and louder variation of that same theme. The potential election of populist political parties in Italy, the Netherlands or France over the next six months could trigger the full-scale destruction of the European Union.

Chart 1: Gold spot price, election day ($US)



Source: Bloomberg

Tipping those future political events is risky, but as the enormity of the US election is digested by financial markets it will also become harder to ignore the possibility of a full-scale European break-up, the abandonment of the region's common currency, the euro, and a return to national currencies.

It's the possible currency shake-up which is the big game that lies ahead for gold, a commodity and a currency rolled into a single asset class.

Does gold stack up?

The question for investors to consider is whether it would be wise to risk exposure to gold in the belief that Europe is next in line for a political revolt?

The answer is that you do not have to believe that Europe will return to a group of sovereign nations with their own currencies, you only have to see gold as an insurance policy against such an event.

> **“The question for investors to consider is whether it would be wise to risk exposure to gold in the belief that Europe is next in line for a political revolt?**

Arguments in favour of gold as a sheet anchor in an investment portfolio, in one of its many forms (bullion, exchange-traded funds or equities) remain as valid today as before the US election for one very simple reason: no-one knows what’s coming next.

Some normally restrained analysts are quite excited about gold. HSBC Bank sees significant changes in currency values ahead with the US dollar weakening against the euro, the yen and the Swiss franc.

“Gold prices would also likely extend their rally given its safe haven status,” HSBC said on Wednesday.

“Ahead of the election we forecast gold could rise to $US1500/oz were Trump to win. We would expect much of that move to happen swiftly.”

HSBC was right, for a while. Gold did rally strongly, though the $US1500/oz target was not reached during the panic trading.

Europe is the next big event for gold, and the success of Trump and the exit of Britain from the EU are pointers for an exciting time for gold, a currency beyond the reach of governments.

As Chinese capital markets are liberated, investment in Australia could quite easily double or even triple its current level.

BY CALLAM PICKERING • EUREKA REPORT • 8 NOVEMBER 2016

Positioning for China's cash flood

Capital market liberalisation in China – which involves reducing the regulation and market controls that reduce the free flow of capital across borders – will be one of the major market drivers over the next five-to-10 years. This process will not only provide greater scope for Chinese investors to buy global assets but also allow foreign investors to invest in China.

Key Point

- ***The most likely scenario as this process develops is that Chinese investors will flood global financial markets purchasing equities and bonds, along with physical assets.***

A lot, of course, will depend on Chinese Government policy. In the last 24 hours the country has axed its high-profile reformist Minister of Finance, Lou Jiwei, and replaced him with long-time bureaucrat Xiao Jie.

Australians are already wary of Chinese investment inflows. According to the Foreign Investment Review Board (FIRB), Chinese direct foreign investment in Australian assets totalled $46.6 billion in 2014-15, around one-quarter of total foreign investment, with capital flows almost tripling in the past five years.

Around half of that is directed towards Australian property, mainly residential, with Chinese investment a chief driver of the recent residential construction boom.

Even in a highly regulated market for capital, Australia is receiving close to $50bn a year in investment applications. As capital markets are liberated, investment in Australia could quite easily double or even triple its current level.

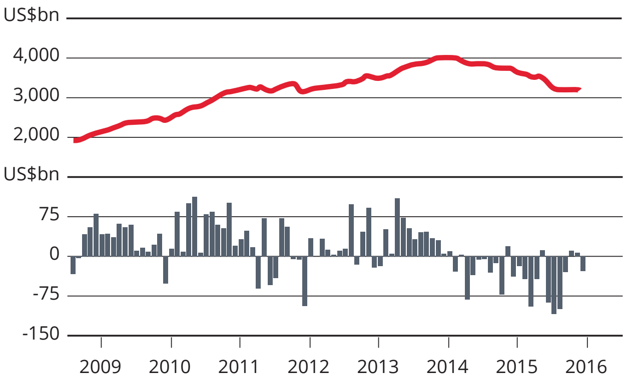
A **research paper** by economist Dr Alfred Schipke, from the International Monetary Fund (IMF) and published as part of a recent Reserve Bank of Australia (RBA) conference on structural change in China, explores some of the implications of capital market liberalisation in China.

Recent developments

This issue gained some prominence following the depreciation in the renminbi in August 2015. Capital outflows from China led to an associated decline in foreign currency reserves throughout that period until early 2016. Chinese authorities reacted via greater enforcement of existing capital account controls.

The problem, however, hasn't gone away, with foreign currency reserves falling by a further $US45.7bn in October and now sitting at their lowest level since March 2011. Among Chinese investors there is a strong desire to reduce domestic exposure, in particular to the Chinese property market, and channel funds towards safe-haven assets and countries.

Chart 1: Foreign currency reserves



Source: CEIC data, RBA

The limited scope to diversify and reduce domestic exposure has created an internal boom-bust financial environment that hit Chinese equities last year and has spread to commodities such as iron ore and coal during 2016. The recent improvement in commodity prices has partly been a product of speculative investment in commodity futures. (Also see ***A big margins call for iron ore miners*** and watch our recent Eureka Moment video, ***The China syndrome***). It isn't expected to last.

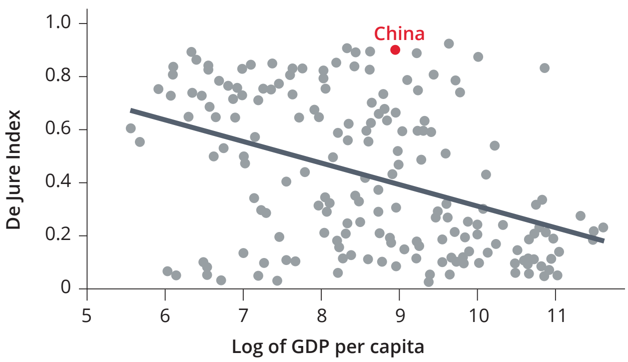
Financial integration in China

China has gradually opened its capital account, but financial integration is relatively low given the country's level of real GDP per capita. Furthermore, the different types of private capital flows – direct foreign investment, portfolio investment and 'other' – have been liberalised at a different pace, creating opportunities and frustrations for domestic and foreign investors alike.

> **"Among Chinese investors there is a strong desire to reduce domestic exposure, in particular to the Chinese property market, and channel funds towards safe-haven assets and countries.**

Chart 2 compares financial integration in China against other countries on the basis of real GDP per capita. As we can see China is largely an outlier globally, with relatively closed financial markets. As financial liberalisation continues we expect China to begin to converge with that trend-line.

Chart 2: *De jure* financial account restrictiveness and income level

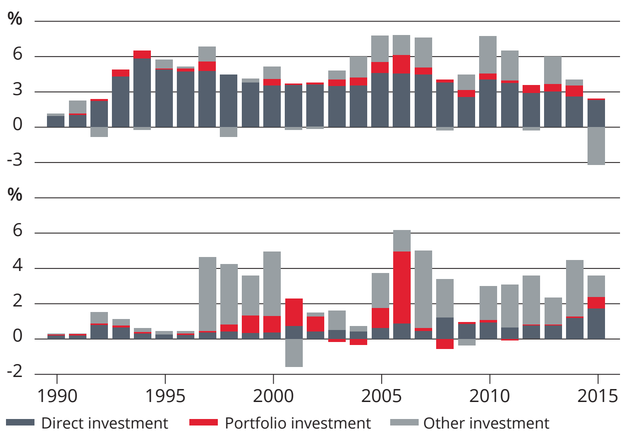


Notes; 185 IMF member countries, including their territories where date are availat

Inflows and outflows

Foreign direct investment (FDI) has dominated capital inflows to China because there are fewer restrictions surrounding these investments. FDI refers to investments made in either establishing business operations or acquiring business assets.

Chart 3: Capital inflows and outflows (% of GDP)



Notes: Gross inflows are defined as the sum of inward foreign direct investment, portfolio liabliities and other investment liabilites in the balance of payments statistics; gross outflows are defined as the sum of outward foreign direct investment, portfolio assets and other investment assets.

Source: Thomson Reuters

'Other' flows are mainly banking related and have become increasingly prominent in recent years. Investment via the banking system has been a key pathway through which capital has left China.

Chart 3 compares capital inflows and outflows. We can see that portfolio investment, which is the category of most relevance to Eureka Report readers, is heavily restricted. Portfolio investment will be one of the major beneficiaries from further capital market liberalisation but we would expect to see an increase in both inflows and outflows (as a share of GDP) as capital markets are opened up.

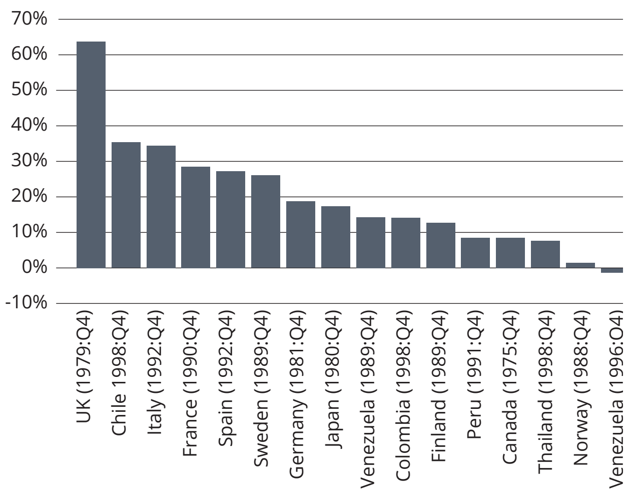
Implication of full liberalisation

Dr Schipke explores the implications of full financial liberalisation. Such a scenario is unlikely, particularly in one go, but it does provide some insight into how capital flows may adjust to deregulation.

In the past, "countries that liberalised their capital account generally experienced a significant increase in both inward and outward capital flows." In most cases, "outflows were larger than inflows as domestic investors sought to diversity their savings." The most likely scenario as this process develops is that Chinese investors will flood global financial markets purchasing equities and bonds, along with physical assets.

Chart 3: Capital inflows and outflows (% of GDP)

Five years following capital account liberalisation, % of GDP



Source: Thomson Reuters

> “ **In the near term the most visible sign of Chinese capital outflows will be felt in currency markets.**

Chart 4 compares the international experience of economies that have gone through a similar process. Whether an economy is large or small, financial liberalisation typically ends up with strong growth in capital outflows as investors take advantage of new investment opportunities.

Nevertheless, there is a great deal of uncertainty surrounding the response of investors to new opportunity; recent history, however, suggests that Chinese investors will embrace financial deregulation enthusiastically.

Research suggests that the net capital outflow from China in the event of full liberalisation could range between 11 and 18 per cent of Chinese nominal GDP. That is around $US1.25 to $US2.1 trillion based on nominal GDP in 2016 dollars.

There are risks associated with opening up markets too quickly. Capital flight is a risk that has proved disastrous for emerging economies in the past, but there are also risks associated with waiting too long. Finding the right balance is difficult and Chinese authorities have so far shown a desire to take a slow and gradual approach.

A closed capital account can distort capital flows leading to an inefficient allocation of capital. A ‘housing bubble’ is an example of a distortion caused when capital cannot flow to where it is most useful. The recent speculative booms and busts in equities and commodity futures is another example. One of the reasons that capital is flowing out of China, through legal and not so legal means, is to avoid the risks associated with such distortions.

Liberalisation of Chinese capital markets represents a significant structural change in global financial markets. We have seen the impact that China can have on commodity markets and, more recently, with regards to Australian residential construction. There will be money to be made as Chinese capital floods into Australia and this could prove lucrative for equity and bond owners but also owners of physical capital.

In the near term the most visible sign of Chinese capital outflows will be felt in currency markets. The renminbi continues to fall against other major currencies as capital outflows continue, and this has important implications for Australia.

Domestic investors should closely watch developments in the Chinese currency since a devalued renminbi effectively increases the cost and reduces the demand of iron ore for Chinese steel mills.

A rise in the iron ore price coupled with lower production costs has created a new margins boom for producers.

BY TIM TREADGOLD • EUREKA REPORT • 8 NOVEMBER 2016

A big margins call for iron ore miners

Most investors are familiar with the strong recovery in the price of coal, yet less obvious is an equally interesting development in iron ore where the price might not have risen as far but the profit margins certainly have.

Key Point

- ***How long this mini-margins boom continues – for both iron ore and coal – will ultimately depend on the strength of Chinese demand.***

Lower costs, when combined with the higher price, mean that the biggest iron ore miners are enjoying their most profitable trading since 2011 and 2012, the peak years of the China-driven commodities super-cycle.

Whether the good times can continue is a debatable point, because it is possible that Chinese manipulation of its coal and steel industries is distorting the situation and what arrived quickly could disappear just as quickly.

But even with that "easy-come, easy-go" warning there are hints in the market that the next six-to-12 months could make a material change to the financial strength of iron ore and coal miners, if only to generate the cash to retire more residual debt left over from the boom years.

Chart 1: Iron ore spot price (USD), past 12 mths

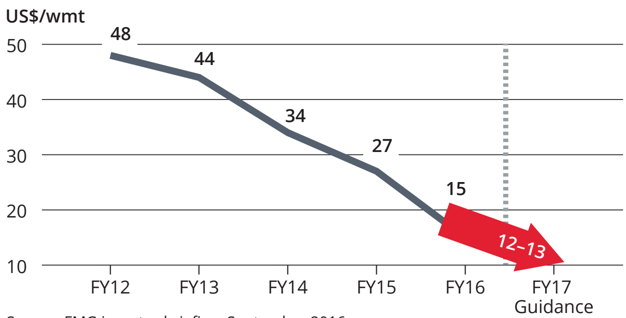
Source: Bloomberg, Eureka Report

One of those hints came last week in the form of a $6.9 million purchase of Fortescue Metals Group shares by the company's chairman and founder, Andrew Forrest, who added 1.32 million shares to the 1.037 billion he already owns at a price of $5.25 a share, close to the peak price of $5.62 FMG reached in late October.

Given that Forrest already has effective control of FMG through his existing 30 per cent stake in the company he hardly needed to buy more as a show of confidence in the stock.

What might have caught Forrest's eye is the gross profit margin that FMG appears to be generating on every tonne of ore it sells, and while that's a difficult number for an outsider to calculate it appears to currently be approaching $US50 – roughly what it was in the boom years.

Chart 2: Fortescue has slashed its costs of production since 2012.



Source: FMG investor briefing, September 2016

The same gross margin estimation can also be applied to the iron ore divisions of BHP Billiton and Rio Tinto using the raw numbers of $US64 per tonne for high-grade iron ore at the close of business on Monday, while the cash costs of the big three have fallen to around $US14/t, and less. Since then, the ore price has shot up to $US67/t.

FMG's case the margin now of around $US50/t is roughly the same as 2012 when it was around $US52, thanks to an iron ore price of around $US100/t and the company's cash cost back then of $US48/t.

gross margin is not the company's profit. To calculate that other charges have to be added, including shipping, a royalty payment and administration costs. There are also interest charges and a provision for capital expenditure.

When all costs and charges are heaped onto FMG's operations the break-even price in the September quarter was $US28.30, low enough to leave a handsome profit. Which is one reason why FMG shares have risen by 280 per cent from their $1.44 low point reached in January to their current $5.47.

> “There are hints in the market that the next six-to-12 months could make a material change to the financial strength of iron ore and coal miners.

Coal at the margin

Similar exercises in estimating the profit margin of coal producers have been carried out by a number of investment banks, including one last week by Morgan Stanley which described the coal situation as a “super-cycle re-run”.

In BHP Billiton’s case its high-grade metallurgical coal mined in Queensland was generating earnings before interest, tax, depreciation and amortisation (EBITDA) in the peak years of the super-cycle of $US146/t.

At today’s price for high-grade coal BHP Billiton’s EBITDA margin for Queensland coal is back to $US144/t.

It’s a similar story, according to Morgan Stanley, with Rio Tinto’s coal operations, which have seen their margin return to $US99/t, close to the super-cycle peak of $US110/t.

What’s happening is that the miners are seeing the benefits of dramatically lower costs forced on them by the collapse in mineral prices over the past few years combined with the sudden and largely unexpected surge in prices.

BHP Billiton’s cash costs per tonne of iron ore in the September quarter were down 19 per cent to $US15/t, with the company forecasting a decline of another 7 per cent to $US14/t.

Rio Tinto reduced its iron ore cash cost from $US16.20/t to $US14.30/t while FMG claimed the title of lowest cash cost producer in the September quarter at $US13.55/t, with a forecast of dropping below $US13/t over the full financial year.

Can it continue?

That’s a question which applies to both the higher price and the lower costs, and of those two factors the one most likely to succeed is costs. The reason for this is because that’s where the miners have control, whereas the price is entirely in the hands of Asian (mainly Chinese) steel mills.

Some investment bank analysts believe the good times of high margins from the twin effect of price and cost can continue for a while.

Credit Suisse said in a commodities note last week that it had expected the iron ore price to fade as it usually does before the northern winter.

“Instead, steel prices are climbing as steel mills push through raw material prices increase which are supporting iron ore,” Credit Suisse said.

“Steel buyers are accepting higher prices, which points to strong demand preventing a glut of raw materials.”

But even with the note of optimism Credit Suisse is unconvinced that the high prices can be maintained indefinitely. It is forecasting a retreat in the iron ore price to $US52 in the current quarter and then down sharply early next year to $US40.

In the meantime, it’s a case of enjoying the ride which comes from the stronger margins created by higher prices and lower costs.

Relying on just market capitalisation to weight stocks within a fund portfolio has its downsides.

BY TONY KAYE • EUREKA REPORT • 11 NOVEMBER 2016

Is smart beta smarter than your average ETF?

In the ever-changing universe of listed financial securities, issuers are continually striving to launch better, more sophisticated, products that offer investors the potential to outperform the market.

Key Point

- ***Smart beta funds are rapidly becoming the new normal for ETFs across global markets, but some say the quest to outperform the market has become more expensive for investors, and there are no guarantees.***

Australia's offering of exchange-traded fund (ETF) products is no different, with a growing number of products now available on the stock exchange that are adding flavour to the blander, so-called "plain vanilla" ETF securities that simply aim to achieve "beta" (the market return) by buying all the stocks within a market index.

These ETFs weight their holdings according to the market capitalisation of the companies within an index, which often means they are overweight in the bigger stocks that are more expensive and underweight in smaller ones that are less popular and generally under-priced. Such ETFs, after taking into account their entry costs and fees, have tended to underperform.

Which is why more and more ETFs, including those listed on the Australian Stock Exchange, are employing investment strategies that the technical financial boffins and asset managers describe as "smart beta".

What is smart beta?

First developed in the United States, smart beta ETFs go beyond the basic market capitalisation methodology of traditional index-following funds and structure their stock weightings not on price but according to fundamental multi-factor metrics such as a company's sales, cash flow, book value and dividend payments.

The US-based firm credited with having founded the smart beta discipline, Research Affiliates, says the smart beta investment approach is aligned to a company's economic footprint and seeks to exploit market inefficiencies by anchoring on factors other than price.

"In other words, smart beta strategies break the link between price and portfolio weight in an effort to deliver better-than-market returns."

By reducing weightings in the most expensive stocks, which usually have a sizeable impact on the performance of an index, smart beta funds offer the promise of enhanced portfolio returns and reduced risk at a low-to-moderate cost.

A major report on smart beta indexing this year by FTSE Russell found that "the smart beta phenomenon has matured to the point that large numbers of asset owners now consider smart beta indexes to be an important part of the investing toolkit."

BetaShares managing director Alex Vynokur, who oversees two fundamentally weighted smart beta ETFs listed on the ASX – the BetaShares FTSE RAFI Australia 200 ETF (QOZ) and the BetaShares FTSE RAFI U.S. 1000 ETF (QUS) – says the strategy is a very disciplined, index rules-based approach that aims to deliver better performance.

"Smart beta provides low cost, transparency and efficiency but also improves performance by removing the link with an index," Vynokur says, adding that for BetaShares' QOZ product, stock rebalances have resulted in investors outperforming the ASX 200 on average by 2 per cent per annum.

"There is the opportunity to achieve outperformance at the cost of an index fund. We're finding in Australia that investors are finding smart beta is a way of achieving alpha (the measure of a portfolio manager's performance), but paying for beta."

Is smart beta just dumb alpha?

While the fees associated with smart beta products, including administration, expense recoveries and brokerage are typically lower than those of actively managed funds, there is a growing voice of opinion they're not overly cheap when compared with market capitalisation-weighted index funds.

Others question whether the performance from smart beta funds in general is really there, and note that market index creation firms are increasingly being engaged by ETF issuers to build bespoke indices upon which their financial products can be moulded.

> Smart beta ETFs structure their stock weightings not on price but according to fundamental multi-factor metrics.

"They're not real indices, and the issuers are then charging a lot for market-led algorithms that are based on back-tested data but which won't necessarily work in the future," says a financial products expert. "It's an accident waiting to happen."

He's not alone. Among other detractors is Research Affiliates' co-founder Rob Arnott, who in a February article *Beware of rising valuations in smart beta* warned that a "stampede in popularity" was pushing up the prices of some smart beta funds to bubble proportions.

"Is the financial engineering community at risk of encouraging performance chasing, under the rubric of smart beta? If so, then smart beta is, well, not very smart," Arnott wrote.

"It's dangerous to ignore relative valuation outright, and to go ahead and load up on a factor just because its past performance has been brilliant."

Smart beta lessons

Jonathan Ramsay, a director of Sydney-based ETFs portfolio construction firm InvestSense, says that many of the products available now in Australia are income focused, and have underperformed the market.

"There seems to be a tendency for factor/smart beta ETFs (and sector-based ETFs) to be launched following strong performance by the factor (sector), which may expose investors to the risk of subsequent underperformance," Ramsay says.

"This has been noted in overseas markets where there is greater availability of ETFs but it is especially prevalent amongst the limited number of predominantly income/dividend focused products in Australia.

"On the other hand, there is some evidence that active income products have performed just as poorly recently, as the world started to think about the possibility of higher interest rates."

He adds that investors should think carefully about what the total return expectation of the smart beta ETF is (or ask someone who has thought about it and has the ability to look through the hype).

"In the case of dividend/income focused ETFs the thought should have been 'can I accept the downside?'," Ramsay says. "High income payers should theoretically underperform over the long term.

"Sometimes it might be better to wait through one cycle and have a tendency towards a factor that hasn't necessarily delivered outsized gains in the recent past, but where you think the future looks brighter."

Vynokur says that, fundamentally, investors should not just focus on ETF performance but the methodology behind the product.

"I would caution investors that they really understand the merits of the methodology and that it's not just a back-tested model that doesn't relate to the realities of the investment world.

"We, as a business, do not necessarily take the view that one way of indexing is the Holy Grail."

If you earn more than $100,000 from DB superannuation income streams, get ready for higher taxes.

BY BRUCE BRAMMALL • EUREKA REPORT • 10 NOVEMBER 2016

The new rules for defined benefit schemes

It has escaped the limelight because of its complexity, its legacy nature, and the smaller number of Australians who are impacted.

Key Point

- ***The first $100,000 will continue to be tax-free for funded taxed funds, and taxed at 50 per cent for amounts over that. Unfunded DB income streams are fully taxable, with a capped tax offset.***

But defined benefit super pension income streams weren't forgotten when the Turnbull Government turned the heat on, and the taxes up, on superannuation earlier this year.

Millions of Australians have DB funds, though most were closed to new entrants 15-20 years ago.

Anyone earning a reasonable sum from superannuation income streams, with any part of that coming from a DB fund, will feel the impact of further taxes on their retirement incomes.

That "reasonable sum" is considered to be $100,000 a year. If you earn more than that from DB superannuation income streams, get ready for higher taxes.

The problem is … how much extra tax is not perfectly clear at the moment for those who have pension income streams coming from multiple sources.

The new super rules outlined that $1.6 million is a reasonable sum to have in a tax-free environment inside a superannuation pension fund. And for the majority on defined contribution (DC) funds, this is a reasonably simple amount to calculate.

But DB funds aren't so simple. DB funds end up producing income streams that are based on length of service and a salary multiple. (Every one is different.)

To keep things simple … oh, that's a laugh … nothing about DB funds is simple. And the Government isn't making it any simpler. But let's give it a go.

Taxing DB income streams

The Government has essentially declared that an income of $100,000 (that is 1/16th of the $1.6m transfer to pension cap) will continue to be taxed at lower rates.

For funded taxed funds, the first $100,000 will continue to be tax-free. For amounts over that, 50 per cent will be taxed at marginal tax rates. So, for someone who has a $180,000 taxed DB fund income stream, $100,000 will be tax-free and $40,000 (half of the extra $80,000) will be taxed at marginal tax rates.

And then there are unfunded DB income streams, that are fully taxable. They are currently taxed at marginal rates, but the recipient receives a tax offset of 10 per cent. The offset will, from July, be restricted to the first $100,000.

Therefore, someone earning $140,000 from an untaxed DB pension would currently receive an offset of $14,000. But in the future, this will be limited to $10,000.

Everything in excess of $100,000 will be taxed at marginal tax rates.

What happens with multiple pensions?

For those with hybrid (taxed and untaxed) income streams, the untaxed will be "stacked on" the taxed.

And if you've also got a regular defined contribution fund on top of that … watch this space. I have not yet seen clear advice on this. My understanding is that the DB pension side of things will be tallied up first. After that, the DC funds will be allowed up until the $1.6m limit has been hit. Anything in excess will have to be rolled back to superannuation, where it will be taxed at 15 per cent (or 10 per cent for capital gains).

So, someone with a DB income stream of, say, $80,000, would be considered to have $1.28m (16 x $80,000) as part of their $1.6m balance, leaving them with the ability to have another $320,000 in the likes of a SMSF, with the remainder transferred back to super.

New rules for contributions

The Government's handouts say that "notional" employer contributions will be determined under the annual concessional cap in untaxed schemes.

"These will not be subject to Excess Contribution Tax where they exceed the annual cap (as these schemes are taxed in the benefits stage".

> **"Everything in excess of $100,000 will be taxed at marginal tax rates.**

But extra contributions via salary sacrifice will not be allowed, except where the notional amount is taken to be less than $25,000.

For non-concessional contributions, the rules are a little more hazy. NCCs will continue to be allowed, where the balance is under $1.6m. But in some schemes, NCCs are compulsory.

"The Government is still considering the appropriate treatment of excess compulsory NCCs to defined benefit schemes".

The multiplier effect

Some are arguing that the 16x multiplier in regards to the value of the pension is just too simplistic. It will benefit younger members, who might have to pay 20x or more to get a lifetime indexed pension.

But for older members, 75 or 80 or more, an equivalent lifetime indexed pension might well be 10x or less.

As with everything in regards to these changes, simplicity is being removed from the system. And it makes it difficult to start planning – with less than eight months to go – when the Government isn't even sure yet how to finish off writing the rules.

*Bruce Brammall is a licensed financial advisor, a mortgage broker and an expert on self-managed super funds. He is a regular contributor to Eureka Report. To contact Bruce, please **click here**.*

The information contained in this column should be treated as general advice only. It has not taken anyone's specific circumstances into account. If you are considering a strategy such as those mentioned here, you are strongly advised to consult your adviser/s, as some of the strategies used in these columns are extremely complex and require high-level technical compliance.

More details on changes surrounding asset limits and the pension, the bring-forward rule and defined benefit funds.

BY MAX NEWNHAM • EUREKA REPORT • 8 NOVEMBER 2016

Tax with Max: Clarifying the 2017 super landscape

Q. *From one of your recent articles I think the answer indicates that the asset limit to receive an age pension under the rules commencing January 1, 2017 is $816,000. Anyone losing their pension under the rules and getting it back later would be subject to an asset limit of $2.35 million. Does this mean that a couple would be better off losing their pension now and getting it back later, rather than not losing it when the new rules come into force on January 1, 2017?*

Answer: Before I answer your question I need first to clarify the answer I gave in relation to couples who lose their age pension due to the change in the assets test that commences on January 1, 2017. The assets test that will apply is $816,000, and the $2.35m I referred to does not relate to any assets test. It is the value that a couple can have in their superannuation under the deeming rules that relate to the income test for the age pension.

The current income test means the age pension ceases once a couple's combined annual income exceeds $75,357. This means if a couple only has superannuation as their investment asset, and don't earn any other income, they can have up to $2.35m in a super fund under the income test deeming rules. Of course, because their assets will exceed the $816,000 assets test limit, they would not qualify for the age pension anyway.

When couples lose the age pension as a result of the change in the assets test they will effectively be given a Commonwealth Seniors Health Card that is not subject to an income test. Under the current income test applying to a CSHC couples lose the card if their total income exceeds $84,472.

For a couple that does not earn any other income from employment or investments outside of superannuation, under the current deeming income rates that apply to superannuation pension funds, the income limit for a CSHC will be exceeded when the total value of the superannuation accounts exceeds $2.637m.

The major benefit of receiving a CSHC without an income test will be for those people with extremely high superannuation balances, effectively those that that will be affected by the $1.6m pension transfer limit, and those that earn high amounts of income other than from a superannuation pension.

The answer to your question is that a couple will be better off if they lose their age pension as a direct change of the assets test that commences on January 1, 2017. If they lost their age pension before this date it is my understanding that they would not qualify for the non-income tested CSHC.

Q. *In your article entitled Tax with Max: A super property dilemma (September 28) you made the suggestion that before July 1, 2017 it would be possible to make roll forward NCCs (non-concessional contributions) of up to $380,000, being $180,000 for 2016-17 and $100,000 for the two subsequent years.*

In all other advice/commentary I have read this figure has been quoted as $540,000, being $180,000 for each of the three years as per the current NCC limits, presumably because they would be the ones in force at this point in time. Can you clarify/confirm which limit would apply?

Answer: What you have read in other publications could be regarded as being technically correct due to the fact that the legislation, to give effect to the changes in the non-concessional contribution limits, has not been passed by both houses of Federal Parliament.

If someone were to follow the advice in the other articles and contribute $540,000 in non-concessional contributions, if they meet the other relevant requirements, they will not be breaching the current limits.

In the announcements related to the scrapping of the $500,000 lifetime non-concessional contribution limit Treasury clearly stated that the measures will take effect once legislated from July 1, 2017. Under the revised limits no further NCCs can be made once a person's superannuation balance exceeds $1.6m. For those people with superannuation balances of less than this limit the maximum annual NCC will be $100,000.

> **When couples lose the age pension as a result of the change in the assets test they will effectively be given a Commonwealth Seniors Health Card that is not subject to an income test.**

The ability to bring forward two years of future NCCs will be retained. Having being taught to be cautious I believe it is prudent to advise Eureka Report subscribers that they should limit their NCCs for the 2017 financial year, if they qualify for the bring forward rule, to $380,000.

This $380,000 is made up of the $180,000 NCC limit for the 2017 year and the $100,000 limits that will apply from July 1, 2017, if the legislation is passed. If the legislation is never passed the current limit of $540,000 would then apply, which means a NCC of $160,000 could then be made.

For someone who has or is turning 65 during the 2017 financial year, and would not pass the work test in the 2018 year, it makes sense to make a $540,000 NCC under the current rules. If the legislation is passed they would be required to withdraw $160,000 as it would be regarded as an excess contribution and penalties could apply.

Q. *What are the implications of the Government's proposal to add income from our defined benefits to our income from SMSFs in determining our tax position? This will very adversely affect those of us who worked hard to save within an SMSF as a supplement to our defined benefits.*

Answer: If the $1.6m superannuation pension transfer limit becomes legislation there has been provision made for it to not only affect account-based pension holders but also those who receive pension income from defined benefit funds.

Defined benefit funds in most cases relate to people who have worked for government institutions and often the pension received is classed as untaxed. Under the current rules someone who is 60 or older and receives an untaxed super pension pays tax at their marginal rate, but receives a 10 per cent tax offset.

To ensure that the limit being placed on superannuation pension accounts is fair and equitable, effectively the $1.6m limit will apply to defined benefit pensions. This is being done by applying a multiple of 16 times to the amount received as an annual pension under a defined benefit scheme.

This means if someone is receiving a defined benefit pension of up to $100,000 there will be no change to their tax treatment. However, untaxed defined benefit pensions over $100,000 per annum will not receive the 10 per cent tax offset.

It would appear that if someone receives a defined benefit pension, and also has an account-based pension, they could be forced to roll back their account-based pension into accumulation phase if they receive more than $100,000 a year as a defined benefit pension.

Where the multiplied value of the defined benefit pension is less than $1.6m people can have account-based pensions that take them up to the $1.6m limit. For example, a person who receives a defined benefit annual pension of $60,000 a year, which has a value using the 16 times multiple of $960,000, will be able to have an account-based pension of up to $640,000.

Standard Chartered, CommerzBank and ANZ have all dismayed investors recently with their declarations not to exercise call options.

BYPHILIP BAYLEY • EUREKA REPORT • 1 NOVEMBER 2016

Surprise! When subordinated bond issuers bite investors

Why is it that investors always seem to be surprised when subordinated bond issuers decide not to exercise their call options?

Key Point

- ***Usually, a reluctance to exercise call options represents changed circumstances for the issuer ... but sometimes one can't help being cynical about an issuer's motivation.***

The call options allow issuers to redeem their subordinated debt sometime before the final maturity date and possibly avoid diminishing capital benefits, as a result. However, the financial condition of the issuer may make redemption unadvisable or market conditions may make redemption uneconomic.

To put it simply, circumstances may have changed.

We flagged last week that **circumstances have changed for AGL Energy**, such that it is now easier for it not to call its subordinated notes when expected. This is not to say that the notes will not be called.

It is not clear that investors price in the value of the call option that is being granted to issuers of subordinated debt. What is clear, though, is that the subordinated debt is priced to the call date and not the final maturity date, hence the dismay when the call option is not exercised.

Standard Chartered and CommerzBank have dismayed investors with their recent declarations.

Standard Chartered incurred a loss in fiscal 2015 and scrapped dividend payments to shareholders as a result. These have yet to be reinstated.

The bank has since returned to profitability but when it recently announced its third-quarter results, which were below analysts' expectations, it roiled credit markets with its declaration that is does not intend to buyback its subordinated debt at the first opportunity. Standard Chartered is focused on building up capital ahead of any Basel IV imposts and on improving return on capital.

A few days later when Commerzbank reported a Q3 loss, the CFO advised analysts, on a conference call, that he sees no need to buyback subordinated debt. The price of $US416 million of 6.352 per cent Tier 2 capital issued by the bank fell to 94c in the dollar after the comment. Surprise!

Commerzbank is struggling with the costs of negative interest rates in Europe and increasing regulation. It was restructuring costs associated with the slashing of 9600 jobs, risky business and risky businesses that caused the Q3 loss.

Commerzbank will not pay dividends to its shareholders in 2017 and 2018. It is refocusing its activities on being a banker to middle Germany, with its international and investment banking activities being dropped.

Circumstances have changed for Standard Chartered and Commerzbank, but sometimes one can't help being cynical about an issuer's motivation for not exercising a call option. An example that comes to mind is much closer to home.

In February 2013, ANZ New Zealand advised the mostly retail investors who had bought $NZ835m of Tier 1 hybrid notes issued in April 2008, that it would not be calling the notes as expected in April that year. The notes would be allowed to run for another five years, at the end of which time a coupon step-up would come into effect if the notes were not called.

That decision saw the annual coupon paid on the hybrid notes fall to around 5.5 per cent from 9.66 per cent. Neither ANZ New Zealand nor its Australian parent was experiencing any difficulties at the time.

How many holders of those hybrid notes will rollover, when the notes are finally called in April 2018?

Philip Bayley is a former director of Standard & Poor's and now works as an independent consultant to debt capital market participants. He is associated with Australia Ratings.