Weekly Review

WEALTH

– Issue – 17 Feb. 2017

We have set up a specialist team to focus on the ETFs market to help guide investors through the complex – and expanding – ETFs universe.

BY TONY KAYE • EUREKA REPORT • 15 FEBRUARY 2017

Eureka Report expands its ETFs coverage

Eureka Report has been closely tracking developments across Australia's burgeoning exchange-traded funds market for some time.

Key Point

- ***More and more self-managed investors are recognising the advantages of being able to readily buy into ETFs that have holdings in hundreds of underlying listed companies. And licensed financial advisors are joining the rush.***

Now we're moving to expand our ETFs coverage to bring you even more news and analysis on a regular basis, on what is arguably one of the most exciting and dynamic areas of the ASX.

Why are we expanding our coverage? Put simply, the Australian ETFs market deserves more than just a cursory glance.

It's been fascinating to watch as the ETFs product market has gone from a virtual standing start a decade ago to now, where 200 separate products are listed on the Australian Securities Exchange holding around $30 billion in assets.

How is our coverage expanding?

Under the direction of ETFs analyst Philip Bish, our primary focus will be on providing investors with insightful articles to help navigate through the ETFs universe.

This will include reviewing a wide range of Australian and international ETFs already listed on the ASX, as well as the new fund products that are being listed on the market almost every month.

In addition to analysing different ETFs and the various investment strategies employed by product fund managers, we'll also be keep an ongoing watch on ETF market trends as well as changing investor behaviours in relation to capital flows into and out of funds that are exposed to specific asset classes.

We are also introducing a new video segment, Talking ETFs, where we ask product experts to give their insights on what's happening across the ETFs market. This week we talk to BetaShares managing director, Alex Vynokur. **Click here to watch the interview**.

To view all our ETFs content, click into the Portfolios section on the *Eureka Report* website and then into the new Exchange Traded Funds section.

Our expanded ETFs focus will work hand-in-hand with our comprehensive coverage of Australian listed investment companies, and we'll soon be launching a 'Managed Investments' area on the *Eureka Report* website to house all our content on ETFs, LICs and other managed products.

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ETFs growth is mushrooming

Australian investors are set to channel record amounts of capital into exchange-traded funds this year, taking the total value of investments in locally-listed ETF products above $30 billion for the first time.

Indeed, if the 2016 year is anything to go by, inflows into ETF products will continue to surge.

What's very clear is that a rapidly growing band of self-managed investors are recognising the advantages of being able to readily buy into funds on the ASX that have holdings in hundreds of underlying listed companies. ETFs have become the most popular investment vehicle for doing this.

In a single market trade, investors can buy one ETF security that covers a whole index such as the S&P/ASX 200, the US's S&P 500, the UK's FTSE, and hundreds of others. Much further than that, there are ETFs on the Australian market that hold parcels of stocks in companies and securities providing exposure to specific sectors such as property and infrastructure, and to asset classes such as fixed interest and cash.

The Australian ETFs market broke new ground during 2016, with strong investor demand driving a 22 per cent increase in invested funds to $25.7bn. A total of 40 new ETFs were launched during the year, bringing the total number of fund products on the market at year-end to 196.

Just a few weeks into 2017 and several new ETF products have already been listed, taking the full tally to 200. Expect to see further growth this year in the number of ETFs investing into fixed interest securities such as bonds.

Research by ANZ's ETFs unit shows that Australian equities-focused ETFs continue to dominate the products marketplace, with this segment recording growth of 31 per cent last year as investors focused on a mix of different strategies to diversify their portfolios. The largest inflows continue to be into broad-based Australian equity funds.

Increased support by financial advisors

A report released in January by US-based financial research firm Cerulli Associates found that US financial advisors expect to increase their allocations to ETFs by 25 per cent over the next two years as they move to reconsider the costs of their investment management.

The Boston-based firm said advisors believe that as lower-cost investment products, ETFs effectively translate to less business risk for them. As a result, 45 per cent of advisors plan to increase their ETFs use and to increase client allocations to passive investment products.

The majority of ETFs on the market are considered passive in that rather than using fund managers to try and outperform a particular index, they instead buy all the stocks in the index and weight their holdings according to the companies' market capitalisations.

Expect a similar trend to occur in the Australian market too, with licensed financial advisors more likely to tap into low-cost managed products, such as separately managed accounts that can give their clients access to a basket of different ETFs at once.

These products are designed to replicate specific investment strategies, investing into multiple ETFs that, for example, aim to deliver high growth, growth, income or balanced returns.

Keep track of our enhanced ETFs coverage on Eureka Report by regularly checking our website, emails and by monitoring new article posts on your mobile device.

Disclaimer: Eureka Report's parent company InvestSMART operates managed financial products that invest in a range of ASX-listed ETFs.

A lot could change, but 2017 is looking like a good year for the likes of BHP, Rio and Scott Morrison.

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 15 FEBRUARY 2017

Australia's iron ore cliffhanger

It's almost impossible to underestimate the share market and national income implications of the unexpected rise in the iron ore price. We have seen a minor prelude in the latest **Rio Tinto profit**, but that is absolutely nothing to what will happen if the price stays near current levels.

Key Point

- ***Rio Tinto could double its profit if the iron ore price sustains its current levels; in Canada it has been houses that have been more affected by the slowdown in Chinese investment.***

Meanwhile, a short word about the Commonwealth Bank results. Banking is becoming all about cost management in the light of limited income growth. The CBA achieves small profit rises because its costs are not rising. Longer term, CBA will need to do better.

But did you notice that total customer deposits increased by 4.4 per cent to $541 billion in just six months? Investors are scared. Give them a safe alternative to bank deposits (like government-backed infrastructure bonds) and they will leave. Meanwhile, a lot of Australians are suffering low investment income.

Ore-inspiring

Back to iron ore. It is worth looking at how we got to where we are. I recall about 18 months ago yarning to BHP Billiton executives who were nervous about the long-term implications of the then slightly improving iron ore price. Indeed, the entire mining industry was very nervous and when Scott Morrison estimated his tax revenue for 2016-17 on the basis of an iron ore price of around $US55 a tonne, many thought he was being over optimistic.

The view at the time was that enormous quantities of iron ore were set to hit the market and would depress prices. The additions included Roy Hill's 55 million tonnes, Vale's new iron ore complex (which opened just before Christmas) and higher volumes from both Rio Tinto and BHP.

Indeed Rio Tinto is currently forecasting that the top six producers will add about 100 million tonnes to the market over the next 18 months. Yet the price keeps rising and is now around $US91.

In simple terms, China has reduced its iron ore production from around 400 million tonnes to 260mt a year. So it has absorbed much of the recent extra tonnage, although a large amount of extra ore has not yet hit the market.

The Chinese have closed old inefficient mines and they are also swinging more of their steel output from high energy, high pollution scrap-based plants to modern furnaces which base their steel production on iron ore and high quality coking coal.

And if we want to move down the track a little, if Donald Trump really sets American infrastructure alight he will need a lot more steel and American iron ore producers are inefficient. So companies like BHP, Rio Tinto, Fortescue, Vale and Roy Hill might get an extra boost. The impact of higher iron ore prices on profitability is huge.

For example, Rio Tinto struck an underlining profit of $US5.1bn in 2016 based on an average of $US53.60 per net dry metric tonne. In all it shipped 327.6mt. If the iron ore price was to rise 10 per cent it would add $US880m to Rio's earnings, but currently the price is more than 60 per cent higher than that 2016 level. In addition the full benefit of lower Rio Tinto costs will be felt in 2017.

A lot can happen in the next 10 or so months, but right now Rio Tinto could double its profit. BHP has a wider variety of mineral profit contributors but its 2017 results will also be staggering, although it may struggle in copper depending on how long the bitter strike in Chile continues (Rio Tinto has minority equity in BHP's Escondido mine in Chile).

Scott Morrison's projections in the last budget are going to be realised because of the iron ore price rise. Once upon a time the Australian dollar was linked to the gold price, but now it is partly linked to a combination of iron ore and LNG, which explains why it has performed much better than most people in the market had forecast.

So when you are looking at the Australian outlook start with iron ore and know that if, for whatever reason, it starts to fall – perhaps because China feels the need to increase ore production, or because it is being blocked from exporting to the US – then understand that the outlook for Australia will be less prosperous.

> **"In Canada it has been the houses that have been more affected by Chinese withdrawal.**

Teflon apartments?

To our local housing market, and as I have described before, the sharp reduction in Chinese buying of apartments and other residential properties would normally have lowered prices. But Australians are going for negative gearing.

However, this week the Commonwealth Bank's BankWest put the brakes on the rush to borrow funds for negative gearing by refusing to take into account the tax benefits of negative gearing when assessing how much to lend. At the moment other banks are happy to fill the void but clearly the Commonwealth Bank is nervous. Property on the west coast of Canada in British Columbia has been booming on the back of Chinese investment. As we are seeing in Australia, the volume of Chinese money coming into the main city on Canada's west coast, Vancouver, is falling rapidly and that is having a big effect on the real estate market. Traditionally one might have forecast that the biggest impact would be in apartments but in Vancouver that is not the case.

The big fall was in detached properties where sales fell an incredible 57.6 per cent from the level of January last year. The benchmark price for detached properties was $1,474,800, which represents a 6.6 per cent decline over the last six months.

Sales of apartment properties fell 24.7 per cent but the benchmark price of an apartment property at $512,300 actually rose, fractionally.

It is strange that our banks are really nervous about lending on apartments but 'go for the doctor' in lending on houses, yet in Canada it has been the houses that have been more affected by Chinese withdrawal.

We are watching a trend in major cities towards apartment living and, particularly, apartment living not far from where the jobs are – near the centre of the large cities. This is a community change that is not often recognised. Of course in Melbourne – and to a lesser extent Sydney – there is also a lot of activity in outer suburbia, but once you buy there you usually must allocate large amounts of time commuting, if you work in the city.

And another thing

Two news items really caught my attention in the last few days. The first was the announcement from Ansell that it was feeling the pressure from the Trump camp to increase its production in the US and it was highly likely that, if it doesn't do that, the company will cop a tariff on its goods. Ansell has not made a decision but has been alerting shareholders that the board was watching very closely what trade protection is to be imposed on groups importing into the US. And, of course, going the other way America's Amazon is planning to ship a wide range of retail goods into Australia, including – eventually – food. And China's Alibaba is also coming here.

That is going to put a lot of pressure on our retailers, and the first to publically recognise that they must gird themselves for a fight to the death is JB Hi-Fi, which is particularly vulnerable to a big global electronic thrust from groups like Amazon with its large international buying power. To hold its own against Amazon, JB Hi Fi will need to adopt a set of strategies which very few established companies have mastered.

It needs to set up an electronic retail operation that inevitably attacks its own bricks and mortar retailing. If it doesn't do it, others will. And, as we have seen in so many industries when the online damages the base bricks and mortar business, the major retailer often goes soft on electronic retailing because it destroys the bottom line.

If that is what happens at JB Hi Fi it will be a tough time. And, of course, Bunnings is also vulnerable. Bunnings believes that its style of products will not take off via Amazon. I hope it is right, but a much safer strategy would be to launch a strong electronic presence.

Residential housing continues to be a good investment in Australia and provided you pick the right market and house type, you can do very well.

BY NERIDA CONISBEE • EUREKA REPORT • 16 FEBRUARY 2017

Is there a better investment opportunity than housing?

When Australians have money to invest they look towards the residential housing market, and it's not hard to see why. Investing in housing has been highly profitable for many Australians. In Sydney, our strongest market, capital growth was about 16 per cent in 2016, following growth of 11.5 per cent in 2015. Add to this the more modest, but still positive rental return of around 3 per cent; investing in Sydney housing in 2016 would have netted you a healthy return of 19 per cent on average.

Key Point

- ***Understanding why some areas achieve better growth than others is more important in achieving future growth than looking historically.***

Compare this to other investment types and no wonder so much money is pouring into housing. Australian shares achieved a total return of 11.6 per cent over 2016, but this came on the back of a slow 2015, where they increased by just 3.8 per cent. Shares can offer great investment opportunities but high variability in returns from year-to-year, as well as day-to-day volatility, make them appear a riskier option for some.

The feeling of control that comes from investing in housing is another factor that makes it attractive. As a shareholder in a large company such as BHP Billiton, it's difficult to influence the performance of that business. In comparison, an investment property can be easily improved, tenants can be changed and capital expenditure can be made to increase its value.

Although housing can achieve very high rates of capital growth, the diversity of what's available on the market can mean that picking the wrong location or wrong type of property can also lead to a significant loss. Anyone who invested in Perth or remote mining towns five years ago is now finding things tough, where prices continue to fall and solid tenants are hard to find. Add in the substantial hold costs of owning property (rates, maintenance, etc) with no rental yield and declining value, and there are no automatic guarantees when it comes to property investment.

Are Melbourne and Sydney always a sure bet?

Price growth has been strong in these markets, but in the recent past even these cities have seen a decline. In the past decade alone, prices in Sydney experienced declines in 2008 (following the GFC) and 2012, while Melbourne, although less impacted in 2008, also saw declines in 2012.

Price rises have more than made up for these drops and the declines, but it does show that even in markets that seem a sure bet, conditions can change quickly.

Big diverse cities with strong economic growth and low supply tend to be the best performers, so it's no surprise that Sydney and Melbourne are so strong, and that Sydney sees stronger growth than Melbourne thanks to significantly lower levels of development. In comparison, Perth has far lower levels of economic diversity and tends to go through boom/bust cycles which has a flow-on affect to the housing market.

Beyond very large cities, there are some areas that see greater capital growth than others. Newcastle is currently seeing strong economic growth and is attracting more people wanting to live in that city. It's also not seeing particularly high levels of new development causing lower levels of supply, so it is a good time to consider investing in the city. Tasmania has been seeing very high levels of demand on our site realestate.com.au since the start of 2016 and in Hobart we're now seeing that demand translate into price growth.

What should you look for in housing?

Understanding why some areas achieve better growth than others is more important in achieving future growth than looking historically. Strong economic growth and low levels of supply are generally the best indicators for positive capital growth, however there are other factors which are also worth considering. Suburbs with good retailing, schools and public transport get higher engagement on realestate.com.au and often experience greater levels of capital growth. In areas with a lot of new apartment development, older style

> **Most residential housing investors prioritise capital growth locations, and rental yields are almost always far lower in these areas.**

apartments can suffer but houses will usually fare better. Suburbs in closer proximity to capital cities also do better than those situated some distance away, as many people prefer to live closer to where they work, as well as access the amenities of inner suburban areas.

What about rental yield?

Most residential housing investors prioritise capital growth locations, and rental yields are almost always far lower in these areas. Conversely those areas with high rental yields tend to have almost no capital growth. The higher risk nature of these places makes them less attractive to many property investors. For example, mining towns are currently experiencing almost no capital growth but the rental yields can be quite good.

Is there a better alternative to investing in housing?

Residential housing continues to be a good investment in Australia and provided you pick the right market and house type, you can do very well. However, when investing, diversification is always recommended. With the majority of household wealth in Australia tied to the family home, investing all savings into housing may not be the most sensible decision, particularly if market conditions change. It's important to look at other investment classes in addition to housing to establish a balanced portfolio.

Nerida Conisbee is chief economist at REA Group.

The RBA's forecasts help to shape financial markets including the ASX200 and pricing for government bonds.

BY CALLAM PICKERING • EUREKA REPORT • 14 FEBRUARY 2017

Australia's economic outlook: The four main risks

Despite a surprise decline in economic activity during the September quarter, the Reserve Bank of Australia (RBA) is confident that the economy will record strong and improving growth over the next three years.

Key Point

- ***It is somewhat unusual that the RBA is forecasting lower commodity prices but maintaining a bullish view on growth.***

The RBA's Statement on Monetary Policy, released every three months, paints a fairly optimistic outlook for the Australian economy. It forecasts that real GDP will rise by between 2.5 and 3.5 per cent in the 2017 and 2018 calendar years.

The result is much stronger than the estimate of 2 per cent in 2016, and exceeds average annual growth over the past decade.

Table 1: Output growth and inflation forecasts[a] (%)

	YEAR-ENDED					
	DEC 16	JUN 17	DEC 17	JUN 18	DEC 18	JUN 19
GDP GROWTH	2	1½–2½	2½–3½	2½–3½	2¾–3¾	2¾–3¾
UNEMPLOYMENT RATE[B]	5.8	5¾	5–6	5–6	5–6	5–6
CPI INFLATION	1.5	2	1½–2½	1½–2½	1½–2½	2–3
UNDERLYING INFLATION	1.6	1¾	1½–2½	1½–2½	1½–2½	2–3
	YEAR-AVERAGE					
	2016	2016/17	2017	2017/18	2018	2018/19
GDP GROWTH	2¼	1½–2½	2–3	2½–3½	2½–3½	2¾–3¾

[a] Technical assumptions include A$ at US$0.76, TWI at 66 and Brent cude oil price at US$56 per barrel; shaded regions are historical data
[b] Reate at end of period
Source: ABS; RBA

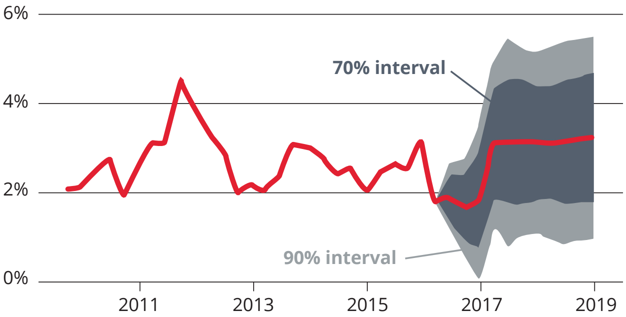
These forecasts help to shape financial markets including the ASX200 and pricing for government bonds. But it is important for investors to realise that there is considerable uncertainty surrounding this outlook.

It's also worth remembering that the RBA has an awful track record when it comes to forecasting economic growth. Reserve Bank research, published in 2012, indicates that there is no evidence that the bank can predict economic growth in either the short or medium-terms.

VIDEO: The RBA's rates dilemma, February 14

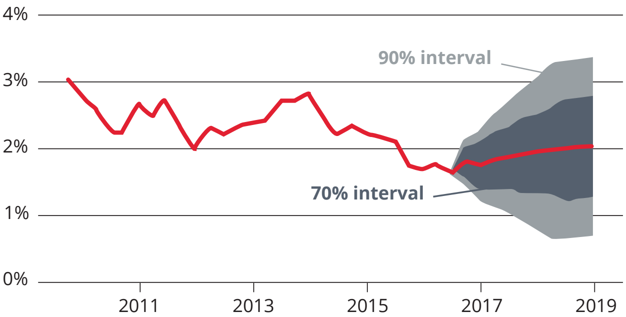
In recent years, there has been a tendency by the bank to overestimate growth and paint an optimistic picture of the economic outlook. Whether this is intentional or a product of modelling deficiencies is unknown but it has resulted in regular downgrades to the outlook.

Chart 1: GDP growth forecast*



* Confidence intervals reflect RBA forecast erros since 1993
Source: ABS; RBA

Chart 2: Trimmed mean inflation forecast*



* Confidence intervals reflect RBA forecast erros since 1993
Source: ABS; RBA

> **"The private sector banks betting on further rate cuts are doing so largely because they are assuming that commodity prices will fall.**

To the RBA's credit, it acknowledge its shortcomings when publishing its official forecasts. The graphs below, contained in Friday's statement, show the confidence intervals surrounding the RBA's forecasts for GDP growth and inflation. The darker intervals indicate that the RBA is 70 per cent confident that inflation or growth will fall within those parameters.

If those confidence intervals strike you as being quite wide, that's because they are. When you remember that market pricing is based on that central scenario, you can get a good feel for the risks facing market participants. This is a useful habit for investors to get into: it isn't sufficient to merely understand the most likely scenario but to also recognise the range of plausible scenarios.

Right now there is a high level of uncertainty surrounding Australia's economic outlook. Market volatility might be fairly mild – some might say too mild – but risk surrounding commodity prices and domestic demand, not to mention geopolitical risks, is high.

The International Monetary Fund (IMF), for example, has urged the RBA to cut the cash rate by 75 basis points over the next six months. They believe that a "'low for longer' strategy would be best suited" to manage the existing low-growth and low-inflation environment.

Both Macquarie Bank and Credit Suisse have declared that the RBA's existing forecasts are too bullish. Macquarie expects rate cuts in May and August this year; Credit Suisse also expects further rate cuts and a downgrade to the RBA's official forecasts in the months ahead.

As I noted in early February, there may be limited scope for the Reserve Bank to cut rates further (***Will the RBA step in to tackle the dollar?***; February 1). Assuming that market conditions hold, with the US Federal Reserve hiking rates by between 50 and 75 basis points this year, the RBA can only afford another 25 basis points of easing before they run the risk of undermining foreign capital inflows and Australia's current account deficit.

RBA Governor Philip Lowe is well aware of the importance of foreign capital to Australia's economic performance.

"Year after year, for more than two centuries now, capital from the rest of the world has helped build our country," said Lowe in a speech delivered in Sydney last week. "If we had had to rely on just our own resources, we would not be enjoying the prosperity that we do today."

So we now have a central bank that is faced with low-inflation and low-growth – both of which they are hopeful will right themselves – while also facing what appears to be a lack of genuine policy instruments.

I don't think that they can deliver on what the IMF proposes and I have my doubts as to whether they can deliver the rate cuts that Macquarie predicts. If the Federal Reserve gets cold feet – or the Trump market rally begins to reverse – then the RBA may receive a little more breathing room that would allow for further rate cuts.

Risks to the outlook

The Statement on Monetary Policy also contains a discussion on the key risks facing the Australian economy. The main risks are discussed below:

1. **The Chinese economy and steel production**

   According to the RBA, "stronger-than-expected activity in the [Chinese] housing market has supported demand for steel" and the "near-term forecasts for iron ore and coking coal prices are predicated on a profile for Chinese steel production that is higher than previously anticipated."

   The rise in commodity prices, driven by stronger-than-anticipated demand for steel, has been a recent bright spot for the Australian economy. It's the main reason why our trade surplus has surged to a record high and in the process supported nominal GDP growth (great for the Federal Budget) and domestic income growth (great for business income and profits and, eventually, wages).

   Nevertheless, "steel production is still forecast to decline gradually because the Chinese authorities have introduced a range of measures that are expected to dampen residential investment" and there are "already signs that these measures are having an effect on housing market activity in some cities."

   The RBA also expressed concern that "the recent policy stimulus has added to already high levels of debt", which "increases the potential for financial dislocation and economic disruption in the future." It speculates that Chinese authorities may need to tighten monetary policy

> **“Historically low rental yields and falling rents across some cities suggest that valuations are stretched.**

to reduce capital outflows and that, in turn, could lead to slower than expected Chinese growth.

2. **Commodity prices and the terms of trade**

There is a great deal of uncertainty surrounding commodity prices and Australia's terms of trade. At the moment the RBA believes that higher commodity prices will be temporary and will be wound down over the forecast period. As a result, it doesn't anticipate that higher commodity prices will "lead to a material change in mining investment, wages or household consumption."

However, if higher commodity prices do persist – or in the process of unwinding don't fall as far as expected – then it creates some upside risk for the Australian economy. National income would be higher than anticipated, feeding into wage growth and pushing inflation towards the RBA's annual target.

Any material change to commodity prices will drastically change the economic outlook. The private sector banks betting on further rate cuts are doing so largely because they are assuming that commodity prices will fall. In light of that it is somewhat unusual that the RBA is forecasting lower commodity prices but maintaining a bullish view on growth.

3. **Momentum in the labour market**

The RBA is forecasting a modest reduction in the unemployment rate over the forecast horizon. Part of the reason is that economic growth over the next three years is expected to be driven by commodity exports, which as a general rule are not considered labour-intensive.

Any increase in labour demand could also be "accommodated by providing part-time workers with additional hours rather than hiring new workers", which would reduce the under-utilisation rate but not the unemployment rate.

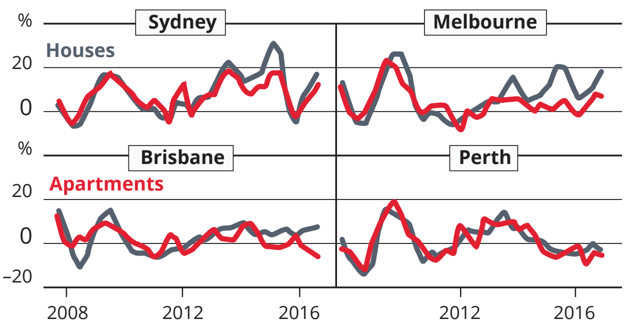
Higher commodity prices could boost employment growth but at the same time we have automobile manufacturers leaving Australia and a lack of investment across the non-mining sector. The safe bet is that the unemployment rate remains at a relatively high level; I expect it to increase towards 6 per cent during 2017.

4. **Housing**

The RBA acknowledges that housing is one of the major sources of downside and upside risk for the Australian economy.

House price growth picked up over the second half of 2016, particularly in Sydney and Melbourne, which could lead to stronger spending and renovation activity. But the risk of a housing downturn is ever present and if one occurs then a "significant number of projects currently in the residential construction pipeline" may be delayed or even cancelled.

Chart 3: Housing price growth by dwelling type – 6mth-ended annualised, seasonally adjusted



Source: APM; RBA

Investor activity in residential markets is currently quite strong but the RBA acknowledges that "history shows that sentiment can turn quickly, especially if prices start to fall." Historically low rental yields and falling rents across some cities suggest that valuations are stretched.

Monetary policy, particularly as it relates to Australia, is in a really interesting spot right now. The optimism of the RBA is coming up against a banking sector that is more circumspect.

Commodity prices and the housing sector are the two areas that warrant close watching – not just due to investor exposure, although admittedly housing and mining stocks are two of Australia's favourite investments – but also due to the effect that these sectors can have on the broader economy.

We have seen in recently years the damage that falling commodity prices can have on federal budgets, private sector wages and inflation. I'm not sure the RBA has the ammunition to manage another collapse in the price of iron ore and coal.

Similarly we can hardly afford a decline in Sydney and Melbourne house prices, although many analysts would argue that we can't really afford an increase either.

Adding in a family investment company could have its advantages, but won't suit everybody.

BY BRUCE BRAMMALL • EUREKA REPORT • 16 FEBRUARY 2017

A fourth pot for your retirement plan

The importance of getting the investment structure right should be no surprise to most *Eureka Report* readers.

And SMSFs and discretionary trusts are often very important parts of those strategies, along with investing in your own names, of course.

Key Point

- ***An offsetting advantage for a company over a trust is that earnings can be held inside a company – and taxed at just 30 per cent.***

But given the deep changes to superannuation hurtling towards us, it's time for some to consider a little-considered option – private investment companies.

It could well become a popular 'fourth pot' of retirement income strategies for many Australians. The advantages won't suit everyone, but there will be some who believe adding another pillar to their wealth creation strategy is worth considering. And today I'll go through the main benefits and disadvantages.

The three-pot strategy

But a recap on the 'three pot' strategy first. For some detail, see this column: ***Your best super moves for 2017***.

1. The first pot is the $1.6 million in super pension. Tax-free, in its entirety. The pension fund pays no tax. And the recipient of the pension pays none either (if you're over 60).
2. The second pot is assets of about $500,000 to $1m outside of super, depending on earnings, that would also be tax free up to the tax-free thresholds, including concessions for older Australians.
3. And the third pot is back in super, in accumulation mode, where earnings would be taxed at a maximum of 15 per cent.

Getting considerably more than $1.6m in super is going to be very difficult for future generations, given the inability to put more non-concessional contributions into super once the total super balance has hit $1.6m.

And from a tax perspective, the three-pot strategy still remains the lowest tax option. But they're not going to be for everyone. And they're not without risk.

A family trust is a possibility for those who are looking to spread income throughout a family. It can have some strong advantages for those with young adult children, where income can potentially be shared. Income and gains can be distributed to reduce tax (personalised advice is required here).

Adding in a family investment company could have its advantages. And today I'd like to go through those.

Family investment companies

Family investment companies offer some advantages and disadvantages that make it a different investment vehicle or structure to SMSFs, trusts and investments in personal names.

For a start, the company tax rate in Australia is 30 per cent. This is considerably lower than the marginal tax rate of up to 49 per cent in Australia. Sure, it's much higher than a pension account (zero per cent) and a super account (maximum of 15 per cent).

But an offsetting advantage for a company over a trust is that earnings can be held inside a company, where trust distributions need to be distributed annually.

And the corporate tax rate is likely to be lowered over time. The Turnbull Government has plans to lower it to 25 per cent, for international competitiveness, but even if they can't get that through the Parliament, it's likely that pressure will be to reduce the corporate tax rate over time.

Earnings can be held in the company indefinitely. The company pays 30 per cent tax on those earnings, but they can sit there, as fully franked earnings, until a time that you (and your partner) need to draw on it.

When the dividends are paid out as income, the franking credits pass through to the recipient and, depending on the income paid, can result in some of the franking credits being returned to the taxpayer.

One downside of this is that the earnings, while sitting in a company, are effectively decreasing in value over time, much like inflation eating into savings. (But the company can, itself, invest, potentially creating further earnings.)

> **From a tax perspective, the three-pot strategy still remains the lowest tax option. But they're not going to be for everyone.**

If the company makes profits while you're in your 50s and early 60s, the money can sit there until you've retired. Then you can draw on that income, as fully franked dividends.

For example, a fully franked dividend of $21,000 is really $30,000 of income, with $9000 of franking credits.

With the allowance for the Senior Australians and Pensioner Tax Offset (SAPTO), older individual Australians don't pay tax until they hit more than $32,000 and couples until above $58,000.

If you don't have taxable earnings from other sources … then you're potentially going to get all of the franking credits back. Don't forget that pensions paid when over 60 are non-taxable. But if you're using the three-pot strategy and have income from the 'outside super pot', then that income would be taxable.

For certain asset classes, companies can be a better taxation structure than a family/discretionary trust. For example, NSW and Victoria charge penalty land tax rates on trusts, that don't apply to companies.

A $600,000 investment property in NSW would incur land tax of $9600 for a family trust, but just $816 for a company. If you held a property in a company for 10 to 20 years, the land tax saved would be considerable.

In Victoria, the trust would pay $2938, while the private investment company would pay just $975.

There are further advantages to investing through a private company. They include:

- Funds aren't frozen in a private investment company. That is, unlike superannuation, you aren't restricted on taking the money out before a certain age.
- There are no contribution limits to a family company. You're not restricted to $35,000 or $30,000 concessional contribution limits, or $180,000 or $100,000 non-concessional contribution limits.

Only when the first three pots are full

The first three pots are still pretty clear favourites.

Nothing beats a super pension fund. Having $1.6m (per member of a couple) in a pension fund, where there are no taxes on earnings or drawings (for the over 60s) is going to be hard to beat.

The second pot of having assets and income in your own name, where no income is paid up to tax-free thresholds (including SAPTO) will also be hard to beat as a second pot. There are risks here, regarding asset protection and bankruptcy.

And accumulation superannuation, with its maximum tax rate of 15 per cent, will be a solid third pot.

But private investment companies could have their place, alongside family discretionary trusts, for further investment holdings.

Speak to a knowledgeable advisor if this might potentially be a suitable fourth pot in your situation.

*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**.*

Self-managed super fund trustees who have taken the plunge into international stocks are showing a heavy bias to US technology stocks.

BY TONY KAYE • EUREKA REPORT • 16 FEBRUARY 2017

Apple is at the top of the SMSF tree

Australian self-managed super funds with direct holdings in international shares have taken a shine to mobile phone and computers giant Apple Inc.

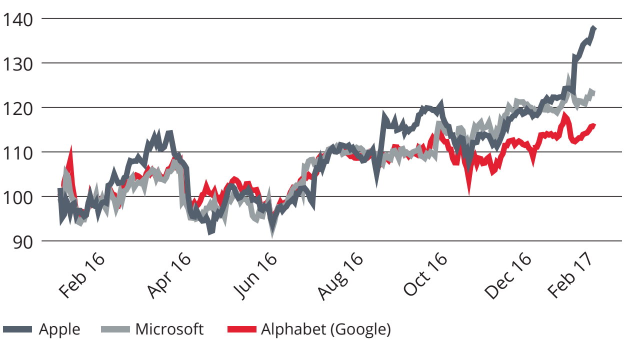
Key Point

- ***Efforts by regulators to clamp down on spruikers luring investors into setting up SMSFs for the purposes of owning property appear to be working. SMSFs data shows only around 1 per cent of funds own a property.***

Data from SMSF administration software group Class, incorporated in its latest SMSF Benchmark Report, shows that just over 10 per cent of the self-managed funds in its research sample with non-Australian shares held an interest in Apple at December 31 last year. Apple accounted for 4.1 per cent of SMSFs' total international shareholdings.

In fact, more than 40 per cent of the 125,000 SMSFs in the research that had invested into offshore shares held stock positions in US technology companies, most of which are listed on the NASDAQ exchange.

Chart 1: US tech bluechips, relative share price growth, past 12 months



Source: Bloomberg

They include shares in Alphabet, the renamed Google, Microsoft, eBay, PayPal, software giant Oracle, and computer chips maker Intel.

Likewise, the biggest Australian stock holding was Telstra, accounting for 5 per cent of total SMSF domestic share investments.

BHP Billiton was next, accounting for 4.1 per cent, followed by Westpac, ANZ, NAB and Commonwealth Bank.

The banking and financial sector is also a major focus for SMSFs venturing overseas, with both Visa and MasterCard ranking in the top 20 holdings along with London's Lloyds banking Group and US banks Wells Fargo and Citigroup.

Meanwhile the Class report, which is based on an analysis of the assets held in SMSFs administered by more than 1,000 accounting, financial planning and specialist administration businesses, found that the majority of SMSFs do not own direct property as an asset, despite popular opinion.

Table 1: International shares, 31 Dec 2016

RANK	SECURITY CODE	DESCRIPTION	% FUNDS WITH INT'L SHARES THAT HOLD THIS SECURITY	% TOTAL SMSF INT'L SHARE INVESTMENTS[1]
1	AAPL	Apple Inc	10.4	4.1
2	GOOG	Google Inc – Class A Shares	6.1	2.5
3	MSFT	Microsoft Corp	5	1.3
4	GOOGL	Google Inc – Class C Shares	4.8	1.2
5	V	Visa Inc	4.4	0.8
6	IGAS	IGas Energy PLC	3.8	0
7	LLOY	Lloyds Banking Group PLC	3.8	0.6
8	JNJ	Johnson & Johnson	3.6	1.3
9	EBAY	eBay Inc	3.5	0.4
10	WFC	Wells Fargo & Co	3.4	0.8
11	FOX	Twenty-First Century Fox, Inc Class B Voting Common Stock-Cdi	3.2	0.8
12	PYPL	PayPal Holdings Inc	3	0.5
13	BRK/B	Berkshire Hathaway Inc	2.9	1.3
14	C	Citigroup Inc	2.9	0.7
15	ORCL	Oracle Corp	2.9	0.4
16	PFE	Pfizer Inc	2.8	0.5
17	AMZN	Amazon.com Inc	2.6	0.6
18	MA	MasterCard Inc	2.6	0.4
19	INTC	Intel Corp	2.6	0.4
20	GE	General Electric Co	2.5	0.5
TOTAL				19

> **“The majority of SMSFs do not own direct property as an asset, despite popular opinion.**

SMSFs owned less than 1 per cent of residential properties in Australia, compared to the 22 per cent owned by non-SMSF investors and the 68 per cent held by owner occupiers.

That SMSF market share of residential property represents about $64 billion of the $6.7 trillion estimated value of the total residential market.

Class chief executive Kevin Bungard said this new data showed that SMSFs were clearly not a significant driver of residential property prices.

“SMSF property purchases are just too small a part of the market to be having a big impact,” he said.

Almost 73 per cent of SMSFs (by number) do not hold any direct property at all, either residential or commercial.

And their indirect exposure to property through listed and unlisted trusts, at an estimated 7 per cent, is not dissimilar to the exposure of APRA funds at 9 per cent.

However, when SMSFs do hold direct property, it makes up about half their assets.

Those SMSFs that do hold direct property have a very significant exposure to it – about half the fund on average is made up of direct property, with proportionally less exposure to cash and shares than funds which don't have direct property.

“These figures are worthy of further discussion and analysis but we should not simply conclude that the members of these SMSFs with direct property are overexposed to this asset class,” Bungard said.

“Many of the members of these funds would have investments outside of their SMSF as well, so you would need to look at the totality of their wealth to be able to draw conclusions about the risks they are taking.”

Sudden death is one of the biggest tax threats for super trustees, but there are ways to get around the looming tax slug that's levied on non-dependents.

BY THEO MARINIS • EUREKA REPORT • 1 FEBRUARY 2017

How to avoid a deadly super trap

As crazy as it may seem, if you have worked hard, saved diligently and used the government's own superannuation system to maximise your benefits, you may still inadvertently leave a 17 per cent Death Benefits Tax liability for your estate.

Key Point

- ***The benefit is that the re-contributed amount is converted to a 100% tax-free component within your super fund, allowing it to be transferred to your non-dependents without incurring Death Benefits Tax.***

This is in addition to the deduction of potentially as much as 15 per cent in capital gains tax by the trustees of your super fund if you die.

This anomaly particularly affects those without financial dependents – and as life expectancy increases, this is a growing sector of the community.

One way around the 'death duty trap' might be to make a full (tax free) withdrawal from super after attaining 60. The success of this strategy, however, relies on knowledge of our date with fate. Fortunately for most of us, this is not generally revealed in advance.

Another 'after age 60' approach, may be to provide an enduring power of attorney including a medical power of attorney (known as an Advance Care Directive or Advance Care Planning) to a close friend or relative. This could provide for superannuation funds to be withdrawn when it becomes clear that life is approaching the final stage. But this strategy too, relies on advance warning. In the event of prior or sudden death, it is simply too late to act and the tax of $17,000 per $100,000 must be paid to the government by the super fund before payment of proceeds to the estate.

The withdrawal and re-contribution strategy

A better alternative to the deathbed switch is the use a 'withdrawal and re-contribution' strategy after age 60. While still relatively complex, prior to June 30 this year this strategy will allow the tax-free withdrawal of lump sums of up to $180,000 for re-contribution as a non-concessional contribution. Using the 'three-year bring forward rule', this strategy could potentially allow withdrawal and re-contribution of as much as $540,000, provided implementation is prior to June 30 this year.

From July this year, provided you are under age 65, a withdrawal and re-contribution strategy will still be possible. However, the maximum annual amount which may be re-contributed will reduce to $100,000 with the maximum single amount reducing to $300,000 under the three-year bring forward rule.

The benefit is that the re-contributed amount is converted to a 100 per cent tax-free component within your super fund, allowing it to be transferred to your non-dependent beneficiaries (including adult children) without incurring Death Benefits Tax.

The Australian Tax Office has indicated that it does not view this strategy as a breach of the infamous Part IVA tax avoidance legislation, but care should always be taken to act in conjunction with advice from a competent financial planner.

Persons aged over 65 but under 75 are also able to 'wash out' taxable components in this way, subject to being able to satisfy the government's 'work test' by working at least 40 hours over a 30-day period in each financial year they withdraw and re-contribute.

The withdrawal and re-contribution strategy is now used primarily as an estate planning strategy, and one which I have been recommending and implementing for the benefit of my clients since the introduction of the 'Better Super' regime in May 2006 – when super and pension payments became completely tax-free after age 60.

A strategy that may not last

The secondary reason for washing out these taxable components has been to future-proof the tax effectiveness of super (in the event of a government reversal of the 'over 60' tax-free super withdrawal status).

“ Persons aged over 65 but under 75 are also able to ‘wash out’ taxable components using this strategy, subject to being able to satisfy the government’s ‘work test’.

Given recent super and age pension rule changes (namely the January 1, 2017 Age Pension asset test changes and the ‘$1.6 million Super Balance Transfer Cap’ from July 1) as well as the current budget deficit problems, perhaps another rule change can no longer be considered unlikely!

After all, these two most recent changes are just the reversal of the Howard government’s easing of certain rules and thresholds during the mining boom, when government revenues were overflowing:

- The Centrelink Asset Test threshold was eased around 1999–z2000 and from January 1, 2017, it has really only been returned to about where it was originally.
- The new $1.6m transfer cap rules are also designed to reinstate a version of the old Reasonable Benefits Limit (RBL) rules that applied prior to the Better Super regime announced in May 2006.

For this reason I now tell my clients *not* to put off their withdrawal and re-contribution strategies, as I expect this too to appear on the radar of Treasury, with the possibility that this strategy opportunity may not be available for very much longer.

I also advise my clients that due to the $1.6m cap rules, a re-contribution strategy is likely to be more complex than it used to be and, particularly for those with larger balances, care will need to be taken not to exceed that cap.

For those fortunate enough to have more than $1.6m in super, further non-concessional (tax free) contributions will no longer be possible after July 1. If it is still possible to take this action, however, it should be considered before June 30. The alternative will be to wait until the Balance Transfer Cap is indexed to $1.7m (this will occur only in amounts of $100,000 every two to three years) and at that point it will only be possible to make up the increase.

If you are eligible to implement a withdrawal and re-contribution strategy, and have the superannuation assets to be affected, it would be wise to seek and act on advice quickly.

Theo Marinis is a financial strategist and head of Marinis Financial Group.