

dimensions

insights for financial services executives

Wealth management strategy and product specialists

From insight to implementation

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Life with less super, more offshore funds, and other “under the radar” Rudd reform impacts

The history of federal government intervention in the national savings system is nothing if not consistent.

The strong temptation for successive governments from each side of politics to ‘tweak’ the superannuation system is such that the industry now routinely expects its annual May dose of system reform.

So it was that the May 2009 Budget included a number of controversial policy changes. There may well be further policy refinements ahead – the furore over employee share schemes and the increase in the age pension age are just two examples where decisions may be amended.

For providers of financial services products, Tria sees three key areas where the impacts must be carefully assessed. They include:

- Slashing the concessionally taxed super contributions cap.
- Repeal of the FIF provisions.
- Increased government bond issuance.

Less super = more what?

Non-super products are back. Super has started to be scaled back from its position as the all- dominating investment structure and now looks a little risky from an investor access point of view. Having been almost moribund other than what could be sold into the super funds, non-super products will return as important complements to an individual’s super arrangements.

The cut in the contributions cap has a certain whiff that someone in Canberra has been itching to go after “the top end of town”. But, as with employee share schemes, in doing so, it’s almost impossible to avoid impacting a lot of average Australians and creating undesirable second round effects.

Let’s be clear about the extent of the change: it’s huge and will affect a significant number of people.

Firstly, the cap has more than halved:

Concessional cap for 2009/10	\$55,000
New concessional cap	\$25,000
Reduction	55%

The cap was likely to increase from \$50,000 to \$55,000 in the coming year due to indexation, so the cap reduction is actually a cut of 55%, with a restart of the indexation!

Secondly, while it may be true that on the Government's numbers, only 19,000 Australians contributed more than \$25,000 in concessional super last year, this greatly oversimplifies the issue.

For many Australians, traditional financial wisdom dictated paying down the mortgage, with the intention of lifting super contributions significantly later in life. There's also a segment whose balances have taken a beating in the GFC bear market, and now need to top-up in order to retire with enough money in super.

These strategies just got torn up- and it is going to affect many relatively ordinary people, late in their working lives. The feedback from a number of Tria's industry fund clients (who have adequacy and member engagement issues to contend with) is they are less than amused.

So the 19,000 figure of those affected is superficial to say the least – it ignores the people who were planning to increase the contributions significantly in years to come.

In addition, despite recent denials the Government spooked the horses further by allowing the perception to arise that the super preservation age might be aligned in some way with the increased pension age.

So now Australians saving for their retirement will be prevented from contributing much to super, and may become reluctant to do so in case it's locked up until age 67!

For those Australians who have higher incomes, receive a bonus, or have simply paid down the mortgage and want to save – what are they now likely

to do? It's difficult to imagine they will simply cough up the top marginal tax rate and invest the net amount. Tria has some likely outcomes:

- Increased use of gearing within super. Some will take the view that if contributions to super are limited, you need to get maximum juice by gearing up, mostly via warrants and internally geared funds.
- Increased use of gearing outside of super – both margin and home equity lending facilities, and via structured products. Most high tax rate investors want some degree of tax sheltering, and gearing is an obvious way to achieve this. Some of this geared investment will go into equities, but a lot will also go into real estate.
- Increased use of tax sheltered investments (once the memory of Timbercorp and Great Southern has faded a little).

So the second round effects of this policy include:

- thwarting the retirement plans of thousands of ordinary people,
- increasing risk levels inside and outside of super, and
- diverting investment from productive to non-productive asset classes.

Not exactly the right lessons to draw from the GFC in Tria's view.

But it's good news for fund managers' unit trust ranges, and great news for investment lenders. It should encourage plenty of innovation around higher risk assets and strategies, and how to best tie this in with super.

In the event that the super preservation age is ultimately increased as well (though Prime Minister Rudd has recently ruled this out in the short term) there is likely to be substantial demand for income products in the period between which people actually want to retire and when they can access their super.

FIF repeal to revolutionise global investing

Welcome to the world of UCITS. If you don't know what that stands for, you'd better learn fast.

While the detail is not there yet, it looks like the FIF nightmare will be completely repealed and its replacement will penalise only non-distributing offshore entities. On our reading, common offshore vehicles such as US mutual funds and distributing UCITS products will be acceptable.

This will revolutionise the way in which Australians access offshore assets and is a big win for offshore managers. While super funds have been exempt from FIF for some time, unit trusts have not. Retail platforms in particular have been forced to operate within the de minimus rules, in practice a major obstacle.

Offshore managers have not been able to fully use their scale – their fund complexes have not been marketable outside of institutional super (which tends to use mandates anyway), and local unit trusts been unable to feed into them. This has been a significant problem; for example in order to launch a new global equities fund, it has been necessary to find enough seeding clients up front in order to fund a \$50m+ discrete portfolio.

This is now swept away. At this stage we doubt we will see widespread direct distribution of foreign funds – there are still some tax issues (eg franking credits, US estate taxes) and local regulation and disclosure issues to deal with. You would generally also need an Australian PDS for example. Local investor needs and preferences need to be kept in mind.

However we see extensive applications within feeder fund and multi-manager structures, which have an Australian unit trust facing the investor. The Australian unit trust will now be able to invest into units / shares of distributing offshore funds and gain instant scale.

The ramifications are important. Local and offshore managers will be able to offer new products without having to worry about finding the money to fund a discrete portfolio. More niche products will become viable. For a lot of offshore managers, it has been unattractive to offer local pooled funds in addition to mandates; many have not bothered as a result. This should change, and over time, we should expect to see more entry and wider availability of funds, creating more choice in international investing than is the case at present.

Investors will win; for managers the challenge is to choose judiciously from the options now available without over-extending the product range.

We believe the big winners will be fund managers offering a UCITS structure. The preferred fund platform of global managers, UCITS is dominant in Europe, and increasingly accepted in Asia and Latin America. Fund managers could create an \$A class of their UCITS platform and offer it directly; or given investor tastes, more likely create an Australian unit trust which feeds into it.

Over time, it is likely to make sense for smaller locally managed discrete portfolios to be collapsed into a larger UCITS or other structure. This will likely mean less work for Australian portfolio managers, but many exciting options for Australian product developers who will have a much bigger cupboard to choose from.

By the way, UCITS is a mind boggling European Union acronym for Undertakings for Collective Investments in Transferable Securities.

New life for fixed income products?

With \$300 billion in government bonds to be issued in coming years, the composition of the UBSA Composite Bond All Maturities Index is likely to change significantly. This will mean greater liquidity and less

credit in the benchmark, with flow-on effects to fixed interest portfolios.

The limited bond issuance of the past 5 years has seen a drift down the credit ladder as fixed interest and income funds have sought to put the inflows of yield hungry investors to work.

While there are plenty of government guaranteed securities in the market thanks to bank issuance, this is not a substitute. In particular, these securities can be relatively illiquid. With many more government bonds available, we may see a crowding out and / or repricing.

For product providers, this creates something of a dilemma. Adding government bonds back into fund portfolios may result in less volatile offerings, certainly less exposure to sudden credit losses, better underlying liquidity, and a product closer to investor expectations of a fixed interest investment.

But do investors actually want this? When fixed income markets were last dominated by government bonds, retail investors weren't particularly interested in funds based mainly on government bonds. The category never became particularly big. A second problem is that active fund managers have struggled to add value in government bond portfolios, especially at retail pricing. In an environment of low bond yields, fees will take a big bite out of the return available for investors.

It's more likely to be a case of working out where Australian, foreign government bonds, and government guaranteed securities – there will be plenty to choose from – fit into a diversified income solution. This is a big market, and now that the shortcomings of traditional solutions such as credit have been so clearly demonstrated, it's one in need of new approaches.

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