



JANUARY 2015

Welcome

Welcome to the January AIA 'Investor Update'. I trust that all of our members and friends had an enjoyable holiday break, and are up for the investment challenges of 2015. Some interesting reading this month. The article about the ATO view on cross insurance is interesting, as is Colin Nicholson's article on stop losses and also Nick Radge's trading article.

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New ATO view on cross-insurance within an SMSF!

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There has been much conjecture as to whether a self managed superannuation fund ('SMSF') trustee can implement a cross-insurance strategy after 1 July 2014. The ATO recently addressed this question; which is discussed below.

However before discussing the ATO's view, we begin by briefly discussing what cross-insurance is.

Upcoming Events

Perth Information Meeting

Retirement income driven strategies
7.30pm 3rd February 2015
Wembley Downs Tennis Club

Blackburn Discussion Group

7.15pm 4th February 2015

Hills District Discussion Group

7.00pm 4th February 2015

Brisbane Information Meeting

Economic Outlook, Chris Caton
1.30pm 3rd February 2015
Broncos Leagues Club

Kew Discussion Group

7.00pm 4th February 2015

Canberra Discussion Group

7.30pm 9th February 2015

Melbourne Information Meeting

6.30pm 10th February 2015
Telstra Conference Centre

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New ATO view on cross-insurance within an SMSF! Cont'd

What is cross-insurance in an SMSF context?

Broadly, a cross-insurance strategy involves an SMSF trustee taking out an insurance policy over a member's life but deducting the premium related to that policy from another member's account. Accordingly, upon an insured event arising in respect of say member A, the other member's (eg, member B) account receives the proceeds from that insurance policy.

For more detail of how the strategy works, please see our article titled '[Cross-insurance in an SMSF](http://www.dbalawyers.com.au/limited-recourse-borrowing-arrangements/cross-insurance-smsf/)' (<http://www.dbalawyers.com.au/limited-recourse-borrowing-arrangements/cross-insurance-smsf/>).



However, as foreshadowed in that article, there has been conjecture as to whether these strategies could be implemented after 1 July 2014, when changes to the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') took effect.

For completeness, any cross-insurance strategies that were implemented prior to 1 July 2014 will not be affected by these changes and can be grandfathered moving forward. Broadly this grandfathering applies despite an increase or decrease in insurance cover provided that cover continues.

Competing views

Specifically from 1 July 2014, regulation 4.07D(2) of the SISR, now reads as follows:

A trustee of a regulated superannuation fund **must not provide an insured benefit** in relation to a member of the fund **unless the insured event is consistent with a**

condition of release specified in item 102, 102A, 103 or 109 of Schedule 1. [Emphasis added.]

This can be read in two ways.

The first is that the regulation prohibits an SMSF trustee from providing an insured benefit unless it is consistent with a condition of release. That is to say, as long as the insured benefit is provided in relation to a condition of release, irrespective of which member, it is not prohibited.

The alternate view is that one is the precondition of the other. More specifically, the insured benefit must be in relation to that member's condition of release and that the two limbs are in fact linked.

What did the ATO say?

On 17 November 2014, the ATO published its view to the following question:

Can an SMSF take out insurance on a cross-insurance basis?

In response the ATO provided:

Regulations that came into operation on 1 July 2014 do not permit cross-insurance on any new insurance products. These types of insurance arrangements are not permitted because the insured benefit will not be consistent with a condition of release in respect of the member receiving the benefit.

Refer: <https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/SMSF-resources/Questions-and-answers/Can-an-SMSF-take-out-insurance-on-a-cross-insurance-basis/>

Is the ATO correct?

On a strict reading of the regulation, the second condition is not expressly linked to the first. Therefore, the ATO view is not consistent with a strict legal construction of the legislation. If this was the intended consequence, then perhaps the legislation should have read 'unless the insured event is consistent with the member's condition of release'.

However, the ATO may argue that its view is consistent with a purposeful and practical construction of the regulation.

What next?

If you have implemented a cross-insurance strategy before 1 July 2014, then as long as such cover continues, it will continue to be grandfathered.

If, on the other hand, you have implemented a cross-insurance policy after 30 June 2014, then careful consideration should be given to what you do as regulation 4.07D(2) of the SISR is an operating standard, contravention of which, can result in significant penalties.

This may result in other strategies being examined such as whether insurance being held outside of super or via a reserving strategy will prove more effective strategies. Given that an 'insured benefit' is defined for a member to broadly mean a right for the member's benefit to be increased on realisation of a risk, reserving does appear to be a possible alternative strategy. However, if significant insurance proceeds are captured in reserves, then it may result in an ongoing management issue so as not to result in an application of those reserves being added to the relevant member's assessable income if it exceeds his or her concessional contribution cap for a financial year.

We also understand that there may be some interested parties seeking further clarification on the above ATO view. Accordingly, while new cross-insurance strategies should no longer be implemented in an SMSF, it is worthwhile 'watching this space' to see if anything further unfolds.

Note: DBA Lawyers hold SMSF CPD training at venues all around Australia and online. For more details or to register, visit www.dbanetwork.com.au or call Marie on 03 9092 9400.

AIA Assistance Dog "Stella"

We thought it timely to give you an update on our sponsored Assistance Dog Stella. We are very proud of her and our sincere gratitude to all the members and sponsors who donated to make the support possible.

Even though she's an "adolescent" now, Stella is still such a smoocher, she absolutely loves ear rubs. She's no wallflower though and holds her own during playtime with her Super Puppy buddies – three boys Bowen, Bundy and new arrival Parker.

Stella has been working hard at her training and mastering all the basic skills well, such as 'sit, down, stay, stand, come'. Recently she has started learning how to "sit" and "down" tidily next to a wheelchair in preparation for her potential future client - this can be harder than it sounds as she has to learn where to place her legs and tail to ensure she's sitting close enough to the wheelchair but not too close to the wheels!



She is also learning different ways to retrieve items back to someone in a wheelchair. She is learning to retrieve the item by resting her chin on her handler's lap in the "visit" position (a Stella favourite as it means more ear rubs). She's also learning how to pull open her crate door with a special tug to put herself to bed. One cue she is struggling a bit with (that not many of our puppies do!) is "SPEAK", which is their command to bark on cue. The puppies learn this so that should their owner be in trouble, for instance falling out of the wheelchair, the dog will guard them and continually bark to attract help. Stella's concentrating very hard and we're sure she'll get the hang of "speaking" soon!

Stella recently got to spend an afternoon attending lectures at University with our Dog Instructor. This is all part of her socialisation training so that she easily adapts to lots of different environments, sights and smells from an early age. She was a very calm and well behaved puppy - though she did do quite a bit of snoring so we're not quite sure how much she actually learnt! Stella also had her very first photos with Santa this month, she wasn't fazed by the funny man with the big beard and costume and enjoyed posing with her Carer's three children. We're not sure what Stella asked Santa for, but being a Retriever it's a safe bet that it was food related.

Are Unit Trusts an anachronism?

Boyd Peters

A structural shift in investment preferences is underway and the “traditional” funds management industry is aware of the damage it is causing to the market share they once took for granted. Investor preference is to invest directly in equities, LICs and ETFs, while an ever growing number of financial advisers are using them to build client portfolios.

This is an exciting time to be a part of the wealth management industry. I have not seen such a structural shift in financial planner behaviour since the 1990s when Master Trusts and Wraps gained widespread acceptance.

In terms of the dollars managed unit trust are still the 900 pound gorilla, albeit fighting more competitors - some of whom are growing very quickly and inflicting significant wounds.

As the cost of managing an SMSF becomes cheaper as well as being simpler, money is unsurprisingly flowing into direct equities, ETFs and LICs where discounts to NTAs are moving into (in some cases significant) premiums. Many would contend that this is a structural shift based on the ability of LICs to offer reliable franked dividend streams. These satisfy investors’ needs for reliable income. No one on the “front line” is ignoring the threat this represents.

Industry research shows that self-directed investors prefer direct equities to unit trusts, and the wealthier you are the more you prefer them. Investors’ needs are typically similar- they want dividends, franking, control, transparency, low cost and tax efficiency. Being well educated and typically “hands-on” they also expect engagement from those managing their money. These are features that LICs are renowned for.

To many of these investors the unit trust is avoided where possible. Hand in glove with investment platforms they are viewed as costly administrative vehicle that offer not much more than index-like returns. Further, in many instances they have unknown tax liabilities inside of them. They simply aren’t popular amongst SMSFs and high net wealth investors.

With the aging population more investors have income planning needs. LICs have educated investors that as a company they can have clear dividend objectives, enabling investors to determine how much they will

receive, and when. This compares to the unit trust which relies on income received and realised gains to be able to pay a distribution. In many instances, even as late as June each year the fund manager themselves won’t know if or how much of a distribution might be paid that year.

With the certainty that comes from the LIC structure it is hardly surprising many advisers are departing unit trusts and recommending LICs and ETFs for their clients. In the showdown between “dividends” and “distributions” there will only be one winner- never mind the benefits in cost, transparency, franking and tax.

In the future more fund managers will offer an LIC. Some will be responding to internal pressure of boards asking “why aren’t we doing what our competitors are doing?”, others because they recognise LICs are a structurally superior vehicle and satisfy many needs of investors. Of course some managers will simply be focussed on the revenue available from managing the LICs investment portfolio.

It is conceivable that financial adviser offices/ groups could one day create and issue their own LIC with specially designed dividend policies. That’s still a few steps away due to the need to manage liquidity for bulk applications and redemptions, but eventually there will be a solution to this. Potentially this could be a blend of a unit trust and LIC. With individual adviser groups managing hundreds of millions and in some instances billions of dollars for thousands of clients, creating a \$100m LIC that invests in blue chip Australian equities is imaginable.

One important issue for Fund Managers entering the space revolves around whether they properly understand LICs, and are genuinely committed to supporting them. LICs have specific nuances and unique features- they are a company in addition to an investment portfolio. Directors and management must be prepared to engage directly with shareholders, and manage simultaneous distribution channels with shareholders, media, stockbrokers, financial advisers, investors associations and regulators. These are different strategies from fund manager’s existing distribution channels for their unit trusts.

LICs require skilled personnel who fully understand the intricacies of the LIC as both a company and also an investment portfolio, who are skilled communicators to all stakeholders.....and can operate inside of corporate and legislative requirements. You simply cannot ask your

unit trust sales team to spend a few hours a week on the LIC and take the occasional phone call. The LIC requires a total commitment.

Ancillary to this is that the LIC communicates directly with the shareholder/ investor. Financial planners - with part of their value proposition based on being the intermediary to the fund managers- could feel marginalised by the LIC. With brands, reputations and distribution networks at stake the impact on funds invested in the managers unit trusts is being closely monitored.

The good thing is that where undertaken for the right reasons and properly managed the LIC can be rewarding for all parties involved, including of course the shareholder who is the singularly most important consideration.

It is already interesting observing this structural shift as it has evolved. The magnitude of new entrants offering an LIC revolves around how much the shift from unit trust to direct, ETF and LIC is a structural change as against a cyclical upswing.

My observation is that the clamber of fund managers to offer an LIC is a response to their desire to be meaningful to SMSF and suggests the cyclical story has merit.

I do not expect high LIC premiums to be the new normal, but do expect there is less potential for share prices to drop to too much of a discount. If share prices do slip under their NTA values the yield and franking should be too compelling to keep them there long.

Boyd Peters works for an LIC and was formerly Head of Business Development for a Fund Manager.

Is it best to sell as soon as a stop-loss is hit or to wait for a rally?

Colin Nicholson:

In hindsight, we can always see that in some cases it was better to wait for a rally and in others to have acted immediately. There is no answer to this in real time. A stop-loss is where you are wrong about a trade. If you are wrong, then you should get out and go into a better situation.



Sometimes, it is better to wait for a rally as already observed. But the same result can be achieved by switching into a better situation.

At other times, waiting will bring disaster. Bad news tends to follow bad news.

There is an old saying in Wall Street that your first loss is usually your smallest loss.

Once you are wrong about a trade, it becomes a “hope” trade. Professionals never ever trade on hope. Amateurs do all the time, which is why they get locked into big losses.

Colin Nicholson BEc, SF Fin has been investing his own money in Australian shares for over 45 years. He is one of the very few teachers of investing who publishes his investment return each year. Colin has taught both technical analysis and fundamental analysis for *Finsig*, where he is a Senior Fellow. Colin has written six books on investing and written for *Shares* magazine, *Smart Investor* magazine, *The Australian Financial Review*, *BRW* and now writes extensively in his free newsletter and on his website www.bwts.com.au. Colin does not sell anything except his writing and teaching.

Trading with divergence

Nick Radge.

The world of technical analysis is saturated with indicators, oscillators, lines and other weird and wonderful esoteric attempts at finding the Holy Grail. However there are really only three absolutes; price, volume and time. These items, coupled with patience and a level head for creating positive expectancy, enable us to be successful trading the market.

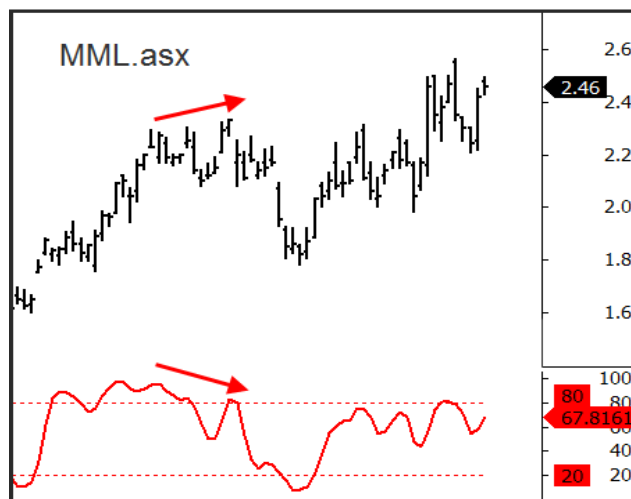
Divergence is a useful indicator, or method, to identify and trade trend reversal moves. Divergence occurs when price moves in one direction and the indicator starts moving in the opposite direction. There are three published versions of divergence known as Type-A, -B and -C, discussed by Dr Alexander Elder in his best seller, [Trading for a Living](#). As the Type-A setup is the most powerful it's the only one that makes an appearance in our Playbook.

There are a number of indicators used to identify divergence including the MACD, RSI, Williams %R and Stochastic. The trick is to pick one indicator and stay with it and not be tempted to chop and change. Most indicators are used incorrectly and thus they tend to be futile when used in the real world. In my [Swing Trading DVD](#) I outline divergence as the only setup that uses an indicator and the indicator of my choice is the Stochastic.

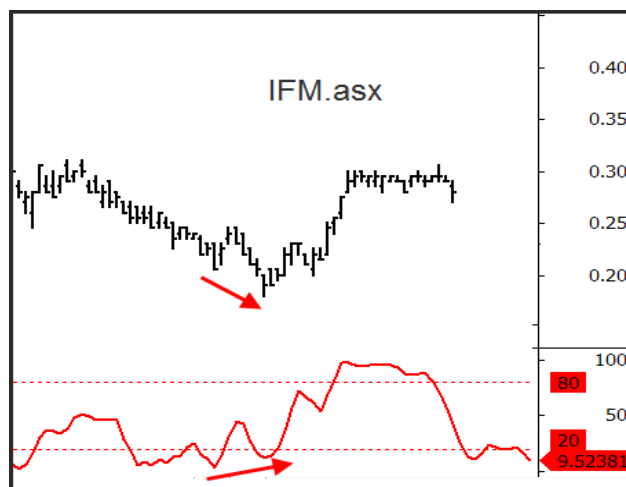
Let's define the Stochastic:

The Stochastic (Slow) indicator calculates the location of a current price in relation to its range over a period of bars. The default settings are the most recent 14 bars, the high and low of that period to establish a range and the close as the current price. This calculation is then indexed, smoothed and plotted as SlowK. A smoothed average of SlowK, known as SlowD, is also plotted. SlowK and SlowD plot as oscillators with values from 0 to 100. The direction of the Stochastics should confirm price movement.

The following chart shows a Type-A Bearish Divergence on the daily chart of Medusa Mining (MML). Prices probe higher but the indicator fails to make a secondary higher high:

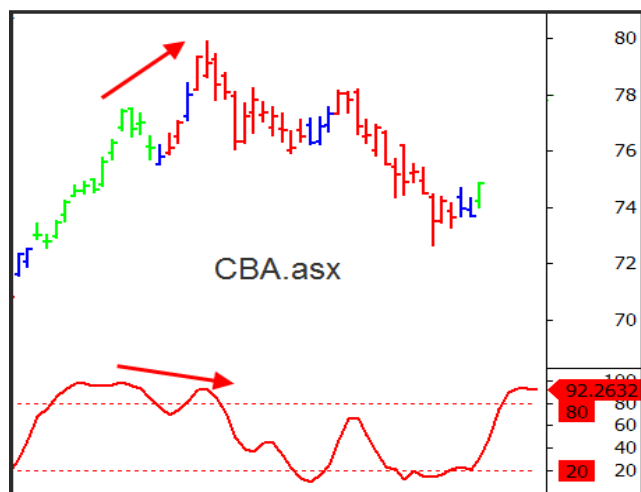


The key to trading divergence is that it must be obvious. If you need to look closely at the chart to measure it, then it's probably best to stand aside and await a very clear example. When a divergence is in place we expect that prices have stretched too far to continue, and either must (a) consolidate for a period of time, or (b) snap back against the momentum. When we trade the setups we're looking for the latter to profit. Infomedia (IFM) offers a Type-A Bullish Setup whereby prices make a new low, but the Stochastic fails to confirm by making a higher low. Note how prices snapped back in the coming weeks.



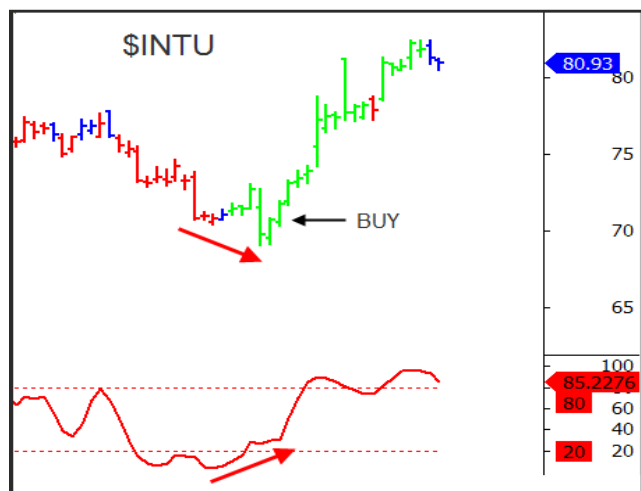
Being a reversal pattern these divergences will be found predominantly against the trend of the broader market. If you're new to trading, or looking for a 'higher probability' outcome, then it's always best to trade aligned with that broader market trend rather than against it. This is very easily spotted and done using our [short term trend filter](#) discussed a few weeks ago. The following chart shows Commonwealth Bank (CBA) trending nicely higher. However the Index Filter switches

from bullish (green) to bearish (red) coinciding with a Type-A Bearish Divergence setup. Over the coming weeks the share price declines almost 10%.



Nick Radge is Head of Trading and Research at The Chartist, www.thechartist.com.au. Nick uses technical analysis for both short term trading and long term investment strategies. He has 27 years' experience in the financial markets from the trading floor of the Sydney Futures Exchange to international dealing desks in London, Singapore and Sydney and has authored several books on trading and investing including his bestseller, *Unholy Grails – A New Road to Wealth*

Our last example shows a Type-A Bullish setup for Intuit Inc (\$INTU). Prices had been falling in alignment with the \$SPX trend, but once that started turning higher \$INTU had a quick spike to new lows to form the setup and then started a new bullish swing surpassing prior highs.



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