

SELF MANAGED SUPER FUNDS

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INTRODUCTION

By Pauline Hammer

Welcome Investors.

In this issue, we have an interesting set of statistical data to share with you.

Firstly, The Australian Prudential Regulation Authority (APRA) has released its Quarterly Superannuation Performance publication for the December quarter of 2009. Note the growth of SMSFs.

How much income is enough in retirement? The Westpac / Australian Superannuation Funds Association (AFSA) Standard have recently released new figures on the cost of living in retirement. The survey was conducted and included the annual budgets of many Australians and their differing financial circumstances and requirements.

Once again we welcome and thank Bryce Figot and Dan Butler from DBA lawyers for their article which provides an update of the government's proposed legislation to amend the tax treatment of instalment warrants.

Finally, we welcome and thank AIA Members, Jon and Margot Kalkman, for their contribution to this month's bulletin – "Our SMSF Portfolio". Jon and Margot established their SMSF in January 2008 and it seems they haven't looked back since.

I wish everyone a relaxing and safe Easter break.

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APRA SUPERANNUATION STATISTICS DECEMBER QUARTER 2009

The Australian Prudential Regulation Authority (APRA) has released its Quarterly Superannuation Performance publication for the December quarter of 2009.

It shows total assets in the December 2009 quarter rose by 3.3%, to a total of \$1.23 trillion.

- **99.9% of all super funds** in Australia are SMSFs.
- The **average total balance** of an SMSF is **\$919,200**.
- The average SMSF **member balance** is **\$460,000**.
- **SMSFs now account for 31.3%** of more than a **\$1.23 trillion market**.
- The average number of **new SMSFs** set up **per month** in the last quarter is **1630**.

The table below shows the **increase in superannuation assets** in the December 2009 quarter for the following:

	Increase (\$B) as at 31 December 2009	Total Assets (\$B) as at 31 December 2009
Corporate	\$0.9	\$59.9
Industry	\$9.1	\$218.9
Public Sector	\$5.5	\$172.6
Retail	\$8.7	\$345.7
SMSF	\$15.6	\$386.1

The table below shows the **increase in the number for funds** during in the December 2009 quarter for the following:

	Decrease/Increase as at 31 December 2009	Total Number of Funds as at 31 December 2009
Corporate	-58	171
Industry	-7	65
Public Sector	-1	39
Retail	-12	154
SMSF	9,705	420,023

Superannuation Industry Summary

Over the December quarter the assets of industry funds grew by 4.3 per cent (\$9.1 billion) to \$218.9 billion, public sector funds by 3.3 per cent (\$5.5 billion) to \$172.6 billion, retail funds by 2.6 per cent (\$8.7 billion) to \$345.7 billion, and corporate funds by 1.6 per cent (\$0.9 billion) to \$59.9 billion.

Contributions to funds with at least \$50 million in assets over the December quarter were \$19.2 billion, with employers contributing \$15.0 billion and members contributing \$3.6 billion. Other contributions, including spouse contributions and government co-contributions, totalled \$596 million.

During the December quarter, retail funds received 32.7 per cent (\$6.3 billion) of total contributions, industry funds 31.5 per cent (\$6.1 billion), public sector funds 29.2 per cent (\$5.6 billion), and corporate funds received 6.5 per cent (\$1.3 billion).

The combined rate of return was 2.3 per cent for the December quarter. The rate of return for corporate, industry and public sector funds was 2.5 percent and retail funds 2.1 per cent.

Copies of the December 2009 Quarterly Superannuation Performance publication are available on Para's website at <http://www.apra.gov.au/Statistics/Quarterly-Superannuation-Performance.cfm>.

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. APRA is funded largely by the industries that it supervises. It was established on 1 July 1998. APRA currently supervises institutions holding approximately \$3.6 trillion in assets for 22 million Australian depositors, policyholders and superannuation fund members.

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NEW COST OF LIVING FIGURES FOR RETIREES

The Westpac / Australian Superannuation Funds Association (AFSA) Standard recently released new figures in relation to the cost of living in retirement. According to the figures, couples seeking a "comfortable" retirement lifestyle need approximately \$57,727 pa, whilst those seeking a "modest" retirement lifestyle need \$28,080 pa. For singles, the required amounts are \$38,611 pa for a comfortable lifestyle and \$19,996 for a modest lifestyle.

The survey benchmarks the annual budget needed by Australians who own their home to fund a comfortable or modest standard of living in retirement. It provides detailed budgets of what singles and couples would need to spend to support their lifestyle. A modest lifestyle is better than Age Pension, while a comfortable lifestyle allows for greater leisure and recreational activities and to be able to spend more on consumer goods and travel.

The figures may be useful when considering how much income you need to aim at generating in retirement. Another guide may be to base the amount needed in retirement as a percentage of your pre-retirement income, for example ("I/we wish to retire on about 60% of my/our current income").

The figures can also highlight the importance of saving for retirement, by considering building superannuation and non superannuation savings, and what sources of income will be available to you in retirement – such as a superannuation-funded pension and the Age Pension.

Source: ING Technical Services February 2010

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GREATER CERTAINTY FOR SMSF BORROWING ARRANGEMENTS

By Bryce Figot, Senior Associate, and Daniel Butler, Director, DBA Lawyers,

Introduction

The government has just announced legislation that will be prepared to amend the income tax treatment of 'instalment warrant'-type loans of super funds. This provides welcome certainty to super fund trustees who have borrowed under these loans, especially in respect of capital gains tax ('CGT') concerns.

Background: why concerns arose

There is a general prohibition on super fund trustees borrowing. On 24 September 2007 an 'instalment warrant' exception was introduced to the prohibition. This exception is contained in s 67(4A) of the *Superannuation Industry (Supervision) Act 1993* (Cth). Paragraph (b) of that provision required that the asset that the super fund trustee acquires with the borrowed moneys be 'held on trust'. Because the asset is held on this instalment warrant trust for the super fund trustee, this gave rise to a number of questions:

Question 1: If an asset is acquired and then later transferred from the instalment warrant trustee to the super fund trustee, is this a CGT event?

Question 2: If the asset generates income while being held by the instalment warrant trustee for the super fund trustee, who declares the income? Should it be the legal owner (ie, the instalment warrant trustee) or should it be the super fund trustee?

Question 3: If, once the loan is paid-off, the asset is transferred from the instalment warrant trustee to the super fund trustee, will this constitute a taxable supply and thus give rise to a GST liability of 10% of the value of the supply?

Question 4: If, once the loan is paid off, the asset is transferred from the instalment warrant trustee to the super fund trustee, will this give rise to a stamp duty liability? This is particularly concerning if the asset is real estate.

The government's announcement

Specifically in the context of an 'instalment warrant' borrowing by the trustee of a super fund the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, announced that the changes will ensure 'that trustees of superannuation funds who have entered into permitted limited recourse borrowing arrangements will not face CGT obligations at the time the last instalments are paid'.

This provides a very welcome answer to question 1, namely being that the transfer from the instalment warrant trustee to the super fund trustee will not trigger a CGT event. There had been different views on whether a beneficiary became absolutely entitled on repayment of the loan, therefore resulting in CGT event E5 event at that time.

Further, the announcement states that super fund trustees 'will be assessed on any income earned on the underlying asset, such as rental income.' Further, super fund trustees 'will be able to claim any relevant deductions, such as capital allowance for the decline in value of property.' Therefore, the answer to question 2 is that it should be the super fund trustee declaring the income. This also is a welcome answer because it means only a tax return will need to be lodged for the super fund and not for the instalment warrant trust as well. Moreover, this clarifies that the custodian or bare trustee does not require an ABN or a TFN.

The law is proposed to apply retrospectively from 1 July 2007. This backdated commencement day dovetails in nicely with the 'instalment warrant' exception, which was introduced several months afterwards, on 24 September 2007. Accordingly, all super funds should be covered.

The full text of the proposal is available at
<http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1724>

A word of caution

Although the above changes have been announced, the actual legislation has not been released yet. Interested parties are invited to lodge written submissions on the design of this proposal. Accordingly, the proposal might be altered and without seeing the exact legislation, it is impossible to say for sure that the changes will operate exactly as announced.

GST and stamp duty

Strictly speaking a transfer from the instalment warrant trustee to the super fund trustee could give rise to a GST liability. However, shortly after the introduction of the instalment warrant exception, the Commissioner of Taxation finalised a ruling confirming that if the instalment warrant trustee was structured and maintained as a bare trust, no GST liability would arise. See Goods and Services Tax Ruling GSTR 2008/3. Therefore, the answer to question 3 is that, provided the instalment warrant trust is a bare trust, no GST liability will arise. In any event the proposed changes clarifying the tax aspects will also hopefully clarify the GST position to overcome the need to rely on a GST ruling.

This leaves the question of stamp duty. Unlike income tax (including CGT) and GST, which are federal taxes, stamp duty is administered by state and territory laws. This means the position in each jurisdiction is slightly different. Although each jurisdiction imposes stamp duty on transfers of certain property (eg, real estate), each jurisdiction also has exemptions that might apply. Many jurisdictions contain an 'apparent purchaser' exemption. This exemption provides that if it can be shown that:

- the super fund trustee was the real purchaser;
- the instalment warrant trustee was a mere apparent purchaser; and
- the super fund trustee provides all the purchaser moneys, including the initial deposit;
- either a nil or nominal duty liability arises. See s 34 of the *Duties Act 2000 (Vic)*, s 55 of the *Duties Act 1997 (NSW)*, s 117 of the *Duties Act 2008 (WA)*, s 39 of the *Duties Act 2001 (Tas)* and s 56 of the *Duties Act 1999 (ACT)*. The Victorian SRO has made non-binding comments on their website suggesting that such exemptions would indeed be available. Many practitioners believe that using a bare trust structure for the instalment warrant trust is very consistent with the 'apparent purchaser' exemption.

Therefore, the bare trust structure is often considered the preferred structure for GST and stamp duty efficiency. Note the recent announcement does not clarify the differences in the state and territory legislation relating to stamp duty and land tax. It would be greatly appreciated if each State and Territory could adopt a consistent approach.

Financial product advice

The Government has also announced that it will require advisers to hold an Australian Financial Services Licence ('AFSL') when changes to the *Corporations Act 2001 (Cth)* ('CA') and regulations are made. Advisers will be given three months from when these changes are made to transition to this new requirement.

Advisers who do not hold an AFSL should therefore consider whether they will need to adjust certain aspects of what they are currently doing in the future in view of this proposal or engage someone with an AFSL. Some banks already insist on an independent financial advisers issuing a written statement of advice and an independent legal opinion before a client proceeds with a SMSF borrowing arrangement.

When the regulations are passed, there is likely to be a requirement for a specific product disclosure document to be issued with each SMSF borrowing package.

Conclusion

Although 'instalment warrant' SMSF borrowing arrangements are still relatively new creatures, there is now greater certainty regarding their use. Accordingly, the authors expect their growing popularity of their use, especially since the Federal tax issues should soon be clarified.

Nevertheless, the documentation will still be crucial and will have an impact on the tax consequences, especially the stamp duty implications.

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OUR SMSF PORTFOLIO

By Jon and Margot Kalkman

Before we retired we were both senior administrators in Queensland government schools. As public servants we were obliged to hold our super savings with QSuper, at least until we retired. With little inclination to become landlords, superannuation seemed to us to be an ideal saving vehicle with tax advantages then through salary sacrifice and now in retirement.

In September 2007 we established an account based pension for my wife as well as a transition to retirement pension for me with QSuper. These pensions were an eye opener. The management fees were a percentage of the investment rather than a fixed fee and there was no transparency about their treatment of imputation credits. We had no control over investment decisions and we were uncomfortable with their policy on death benefits.

Of greater concern was the fact that the pensions were based on units. In retail super funds units are bought during accumulation phase and sold during pension phase. In pension phase, if the unit price goes up with investment growth, fewer units need to be sold with each payment. When the price goes down, however, more units need to be sold to generate the same dollar payment. It is important to note that any sale of units is a permanent reduction of the asset base because money cannot be added to a pension once it has begun.

This design feature of all retail super pension funds along with inevitable fees, inflation and mandated increased withdrawals with age, mean that it is only a matter of time before all the units are sold and the pension ceases. Most people can only hope that the expiry date of the pension is later than their own use-by date. Fund managers and advisors regard this as normal, even with large pension balances.

For us the critical issue in retirement is adequate income. Without adequate income we would be forced to sell assets and when the assets are depleted, we would need to claim the age pension when we are old enough. Having worked hard to acquire our retirement savings we were keen to preserve our assets and their capacity to generate income for as long as possible. Yet, we saw a steady stream of units sold from our QSuper pensions each month and, as unit prices fell at the start of Global Financial Crisis, the sale of units accelerated.

Concerned at the alarming erosion of our retirement savings, it struck us that with sufficient capital we could generate enough annual income that we would never need to sell assets to fund living costs and so the income stream would be assured in perpetuity. Clearly, the asset base and income yield are key considerations. It was simply a question of scale.

The decision to leave Qsuper was not easy as we had little previous experience in direct investing decisions, but the attractions of a self managed super fund (SMSF) convinced us this was a way to take control of our financial destiny with lower fees. It seemed the best way to preserve our assets and set up an on-going income stream. When I retired in January 2008 we set up our SMSF and established a portfolio of direct Australian shares.

We chose Australian shares for yield because, whereas for normal taxpayers the imputation credits help to offset the tax payable, a super pension fund pays no tax on earnings and so these tax credits are fully refunded. In effect, the income yield from Australian shares inside a pension fund is actually the dividend and the refunded imputation credits combined. In most cases the effective or “grossed up” yield is up to 42% greater than the dividend alone. Therefore the capital required to generate our desired income was significantly smaller than first thought. The portfolio was selected to produce a grossed-up yield of at least 6%.

With sufficient income, we do not expect to sell any shares to pay for living expenses so there is every reason to believe that in 20 years time the number of shares in our portfolio will be no fewer than now. What the capital value of those shares will be then can only be guessed at. Moreover, if history is any guide, the income stream from dividends grows faster than inflation. So in time we expect to have the choice to improve our lifestyle or to reinvest excess income into more shares for more income, probably outside the super environment.

We know there is an absolute relationship between return and risk. It is impossible to achieve a high return without an associated high level of risk. We also know that portfolios generating the highest return over time have the largest weighting to growth assets, and therefore asset allocation is more important than stock selection. So we know we need to take enough risk to achieve an adequate return but not so much that we cannot sleep at night.

Many people purchase an asset or a commodity in the expectation that a price change will allow them to sell at a profit. In this case, their risk is price volatility because dramatic price movements can have very negative consequences. The stock market has again demonstrated extreme price volatility and many people seek to avoid its impact on valuations. Market traders use charts and mathematical models to anticipate price changes and to respond quickly.

People selling units to pay for their monthly pension face the same price volatility risk as traders, even in balanced funds. Unlike market traders, however, pensioners in retail super funds have no way of taking prompt or pre-emptive action. Their only protection against volatility risk is to reduce their allocation of funds to shares. Consequently, the standard approach to portfolio construction for clients of managed funds is to allocate their money across a spread of investments according to a risk profile. This approach seeks to manage price volatility risk through diversification across asset classes. While it limits the down-side of volatility by reduced exposure to growth assets, it also limits the upside.

By contrast, we bought assets in the expectation that they will return an annual income similar to interest on term deposits or rent from property. Our dividends are not affected by volatility but by changes to company profits. So our risk is not price volatility; our risk is a reduction in income. Therefore our portfolio allocation is structured around income certainty, not a risk profile. Consequently, we allocated a base amount to cash as a safety buffer, some assets producing high yield to replenish that cash buffer and the remainder to Australian shares.

We hold shares for income and cash for safety. Our cash holding not only protects us against temporary falls in dividends, it also insulates us from market volatility by protecting us against the risk of being forced to sell shares at a time not of our choosing. It means the amount allocated to cash is a function of our income needs, not a proportion of the portfolio and our allocation of funds to shares is determined by the size of the investment pool, not our risk appetite. This has enormous implications for the portfolio's long-term rate of return.

Considered from a risk profile perspective, this approach appears aggressive. From a cash-flow perspective, however, the risks are well managed as we discovered in the crash of 2008-09. Our dividends were certainly lower than anticipated but our cash buffer let us sleep at night. As we had sufficient income we did not sell in a panic. While the past two years have been hugely educational, it is reassuring to know that our investment strategy has been rigorously stress-tested and has withstood the worst market conditions in a generation. We survived the Global Financial Crisis with our investment strategy and our marriage intact.

Although most of our assets are in shares we consider that, with the stability of dividends and our protection against volatility, our approach is conservative.

Although share prices fell by 50%, dividends fell by much less. As share prices fell further than dividends, the grossed-up yield on some shares rose to very generous levels. With our income secure, we are not at the mercy of market price movements and so we could exploit the opportunities presented by price volatility. We were able to add more shares with attractive yields to the portfolio. The market is now factoring in significant upgrades in future earnings and dividends that ultimately will be reflected in share prices and portfolio valuations. With expected growth in income and capital, the future looks bright for income investors like us.

We are not much interested in trading or speculating and trying to time the market for quick gains although we have taken the opportunity to weed out some duds whose yields proved to be illusory. To us, a dividend and imputation credit is money in the bank but a capital gain is maybe-money realised sometime in the future, at which point the income stream stops. Restricting our trading will also reduce our transaction costs and research suggests that we may also keep more of our money in the long term.

We have been strongly influenced by Peter Thornhill from Motivated Money and his emphasis on investing in shares for income, not property, because dividends are linked to growing company earnings, not inflation, nor the growth in wages. I was also fortunate enough to hear a presentation by Dr Robert Vagg at the AIA Conference in 2008. His analysis of the stock market in relation to a long-term trend line that has a remarkable correlation with company earnings was like getting a compass in a foreign land. It provides a map showing when share prices represent opportunities and when they are risky. Both Peter and Robert encourage a long-term view of the stock market.

Although our focus is obviously on income, we are equally interested in companies with quality managements, solid track records of earnings growth and reliable dividends payouts. For most people that fits the definition of blue chips. We hold in addition to our cash the following allocation:

Banks	25%
Consumer Staples	10%
Energy	7%
Financials & Insurance	25%
Health Care	5%
Industrials	8%
Mining & Services	13%
Telecommunications	7%

There are no more than 20 shares in the portfolio. The weighting toward Banks and Financials reflects our pursuit of income. With our income now secure, we want to build up our holding in Energy, Industrials and Consumer Discretionary if, and when, the opportunity presents itself. With little prior experience with direct shares, we sought the advice of a full-service broker. We have no use for specialised software in fundamental or technical analysis.

For a retired couple like us it is very comforting to know that every 6 months the dividends just keep rolling into the SMSF bank account. We use an administrator for compliance with the regulations and legislation. That fee is set regardless of the size of the fund and is the only recurring fee we pay. The administrator organises the audit and completes the fund's tax return. The ATO pays cash refunds of the imputation credits to the SMSF annually. Our pensions are paid from the SMSF bank account and those pensions are tax free to us after age 60.

It is important to note that no assets are sold to fund these pensions as they are paid entirely out of the income earned by the portfolio. Therefore, the assets are preserved to produce income every successive year. Long term this is the difference between a growing asset base, along with its derived income stream, and a declining one.

With a grossed-up yield of at least 6%, we will be at least 80 years old before the income produced by the SMSF is insufficient to pay for the mandatory pension withdrawal. At that time some assets will need to be sold. By then we will have had many years of capital growth and, under present rules, there will be no capital gains tax on those sales. Of course, in lieu of a cash pension payment we could choose to transfer some shares to another ownership structure and the income stream simply continues, albeit under a different tax regime.

This diversified blue chip portfolio provide very little excitement compared to trading small caps, speculating on capital gains or fancy strategies using derivatives or gearing. We feel that having our life savings, except for a cash buffer, invested in Australian shares is enough excitement in retirement. Nevertheless, the simplicity of the strategy really is astonishing:

- Our SMSF allows us to benefit from tax-advantaged yields from blue chip shares thus allowing us to preserve our income producing assets for the future;
- Our risk management is concerned with income certainty, not market volatility and so we are able to benefit from increased exposure to growth assets;
- We have taken control of our finances with minimal fees so we are not sharing our income with fund managers and advisers; and,
- Our portfolio is invested in the future of the Australian economy so we can expect a stable and growing income stream as well as long-term capital growth.

Jon & Margot Kalkman are members of the AIA.

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