Juicy options for retiring mandarins

Some public servants stand to gain if they retire before age 55

TIM BOREHAM

WITH the new Coalition government pledging to slash the size of the federal bureaucracy, it's never been a more nervous time to be a public servant.

Mass redundancies aside, two-thirds of public servants are eligible to retire during the next decade, but few are aware of retirement pension options that can make a huge difference to their income.

That's the view of Adelaide-based financial planner and former public servant Theo Marinis, who is on a mission to raise the awareness of the so-called 54/11 option, unique to members of the Commonwealth Superannuation Scheme.

Post age 55, retiring public servants generally are entitled to a healthy life pension, usually between 40 per cent and 70 per cent of their former pay.

But for proactive pre-retirees it can get much better.

As its name implies, the 54/11 rule applies a different superannuation benefit for members who resign from the public service just before their 55th birthday.

"The option . . . simply means advising the employer that you are resigning before your 55th birthday and then preserving the very generous superannuation benefit you are entitled to in the CSS, until age 55," Marinis says.

Other advisers are slightly more circumspect. "It's a fantastic option but you have to be a bit careful," says financial planner Laurie Ebert, who specialises in advising public servants.

"It may not be automatically viable, it all depends on what the calculation brings up."

Ebert cautions that the difference between the standard and the deferred option has to be significant, "or else there's no point".

Sadly for newcomers, the CSS was deemed too generous and was closed for new accounts from July 1, 1990. The CSS was replaced by the less generous Public Sector Superannuation Scheme, which was closed to new members from July 2005.

But there are still considerably more than 20,000 CSS members, generally aged 40 or older.

The 54/11 advantage arises because the formula used by CSS to calculate the deferred pension is different from that used for calculating the standard pension (paid on retirement after age 55).

In essence, the deferred pension formula is based on accumulated contributions and fund earnings, so investment returns will affect the final pension.

The standard (defined) pension is a formula based on the member's final average salary as well as length of service.

As with the deferred arrangement, superannuants must take a standard indexed pension but also have the option to purchase an additional non-indexed pension with their lump sum accumulation account or receive a refund as a lump sum.

According to the CSS website, "neither calculation is always better than the other; it depends on your personal situation, needs and financial goals".

While the standard pension option sounds more attractive, Marinis contends that "nine times out of 10" the 54/11 approach is more beneficial.

In some cases, the early retiree is better off than colleagues slaving away for another five years or more. "In many cases you would have to work into your 60s to get the same pension," he says.

Ebert cautions the difference between the standard and the deferred option has to has to be significant, "or else there's no point".

And many public servants don't crave an early exit, for any number of reasons.

Ebert says the subdued market performance since the global financial crisis also has dented account balances.

"Three or four years ago there were some amazing figures being thrown up because of high returns, but the subsequent fall in returns has drastically reduced balances," he says.

Of course, nothing is simple when it comes to super, with taxation and social security considerations to take into account.

For instance, a member taking the additional pension option (rather than the lump sum) should bear in mind the payments are non-indexed and thus erode in real value. They are also Centrelink-assessable for future part-age government pension entitlements.

Another variable is whether the 54/11 deferrer (who could be any age under 55) chooses the balanced option or the safer cash option for the preserved sum.

While the latter provides certainty as to the eventual amount on which the pension is drawn, a balanced or growth option offers superior performance over a longer period.

Ebert says he strongly supports the cash option, especially if the member is close to 55: "Most public servants are very conservative anyway."

Marinis urges public servants to seek advice on the available options well before they turn 55.

As for those with a red redundancy target on their forehead, there's some comfort because the 54/11 arrangement is automatically triggered. "Redundancy can be quite distressing, but in fact the 54/11 rules were designed for this situation," Marinis says.

For example, it may be possible to start receiving a pension before age 55, or alternatively opt for a lump sum and forgo any defined-benefit pension.

As for the 200,000-plus PSS members, they cannot avail of 54/11 but they still enjoy flexibility in terms of pension and lump sum options.

"Clearly, careful planning is also required here to ensure you maximise your net retirement income," Marinis says.

Readers should consult a qualified financial planner.

JAMES ELSBY

Theo Marinis of Marinis Financial Group is on a mission to raise awareness of the so-called 54/11 option for members of the Commonwealth Superannuation Scheme

'It's a fantastic option but you have to be a bit careful'

LAURIE EBERT
FINANCIAL PLANNER

Samantha's superlative symphony

FINANCIAL planner Theo Marinis cites the case of a 58-year-old client, "Samantha", who availed herself of the 54/11 option in 2009, after 37 years as a public servant.

On Marinis's advice, she switched her Commonwealth Superannuation Scheme super entirely into the cash option at age 52 in 2006. With the global financial crisis about to hit, that was a fortuitous move.

By tweaking Samantha's pension and lump-sum options, Marinis generated net annual retirement income for her of $53,040, compared with her final-year net salary of $53,488.

Samantha pays no personal tax on her fully-indexed pension, which is $13,000 a year more than had she "waited until age 55 and just ticked the box".

Broadly speaking, the mechanics worked like this:

Samantha took the standard defined-benefit indexed pension option, but fully commuted (cashed out) the additional optional non-indexed pension as a 100 per cent lump sum.

In her case this withdrawal was tax-free because her lump sum was less than her low-rate cap amount (the component you are able to withdraw tax-free post age 55 and before age 60).

This was then recontributed as a 100 per cent tax-free, non-concessional contribution of $226,000, used to start an account-based pension.

"Note the tax-free ABP income supplements her taxable CSS indexed pension," Marinis says.

Samantha pays no personal income tax because each year she makes concessional (tax deductible) contributions to super, which offset her fully taxable CSS pension.

Should Samantha need a lump sum, she can always access the $226,000 tax-free.

Had Samantha opted to take the additional defined-benefit pension under the standard rules for those who retire after 55, the amount would have not been indexed and its real value would have eroded over time.

This pension also would have been assessable for the purpose of claiming a future part government age pension.

"There a lot of sub strategies in this financial symphony," Marinis says. "You need a conductor to make sure it all works for you but the outcomes are classical financial music."

TIM BOREHAM

On the chase for yield

ROGER MONTGOMERY

THE equity market can at times seem like a creature of fashion, if not completely bipolar.

Particular investment attributes, such as high rates of EPS growth or resistance to economic downturn, may attract a premium for a period of time only to fade down the track as other attributes rise to prominence in the minds of investors.

One of the more dramatic examples in recent times was the way the market's views on gearing evolved through the GFC. Before mid-2007, companies with high gearing did not appear to be penalised by the market for the increased risk. Later, when debt became harder to refinance, gearing levels and maturity profiles became primary drivers of the market's assessment of corporate merit.

One characteristic that has risen to prominence is dividend yield. With deposit rates on cash offering poor inflation-adjusted outcomes, investors have been motivated to find better ways of generating income; big, known companies with good dividend yields have been keenly sought. This has not been lost on boards of directors, who have felt under pressure to increase dividend payout ratios or risk the ire of shareholders. In some cases, companies that have delivered sound financial results have been marked down, apparently, due to a lack of generosity in setting dividends.

This focus on yield and the trend towards higher payout rates is not surprising. Or necessarily a bad thing. But an astute investor needs to consider the implications down the track, and whether it presents opportunities or threats.

The first issue is whether higher dividends mean businesses won't have capital available to fund investment in growth opportunities, thereby constraining growth down the track. If a company is able to invest additional capital into its business at a high rate of return, our preference as long-term investors is that it should do so, rather than hand the money over to us.

Of course, this can go two ways. There are plenty of businesses that cannot earn sufficiently attractive returns on additional capital, and yet invest it anyway. In these cases, shareholders would be better served by having the cash paid out to them.

Ultimately, we feel that the risk of good companies being starved of investment capital is unlikely to present a major threat to growth. Where an investment case is sufficiently strong, listed companies usually have the ability to raise capital through new equity raisings, and so it should be possible to satisfy those shareholders who want cash out now, and those who are happy to forgo the cash today in favour of better returns tomorrow.

However, while a trend towards higher dividend payouts might not present issues in terms of the long-term health of the equity market, it may well have implications for how investors should allocate capital. When an investment attribute, such as dividend yield, is in favour, the likely consequence is a rise in the share prices of the relevant companies, potentially pushing them beyond intrinsic value.

This is an important point. Investing on the basis of dividend yield may be a sensible strategy for a single investor, and research indicates there is probably some truth to this. But when the market as a whole decides to invest that way, the investment merit is soon competed away.

Warren Buffett famously said investors should be fearful when others are greedy and greedy when others are fearful. The underlying principle is that it's often good to be doing the opposite of what others are doing, and if others are bidding up the price of yield paying stocks, there is a good chance you will find better value elsewhere.

Our analysis of value in the market bears this out. For example, Telstra, which offers a good dividend yield but limited growth prospects, appear to us to be trading at treacherous levels.

At some point down the track, if interest rates rise and yield falls from favour, there is the potential for material loss of capital on an investment in Telstra at today's prices.

Investing against the trend is not always easy to do, but one thing that we have learned over many years in the market is that the easy thing to do and the right thing to do often are different.

If you have been investing with the flow recently and buying large caps with a high fully franked yield, perhaps now would be a good time to step back from the noise of the market and think about whether a more considered strategy is likely to yield better results in the long run.

Roger Montgomery is the founder of Montgomery Investment Management.

Bega bid sees investors latch on to the udder magic of dairy

UNDER THE RADAR

RICHARD HEMMING

THE food sector is proving to be fertile ground for investors. It has been less than a month since Warrnambool Cheese & Butter Factory received a bid from Bega Cheese, and their shares have rocketed 38 per cent and 15 per cent, respectively.

On Wednesday, Warrnambool told its investors to reject the bid because it was based on its fiscal 2013 earnings, which reflected poor market conditions.

It issued bullish forecasts for the current year, which at the high end of the range is double last year's. Investors have been taking matters into their own hands.

The combined cash and scrip bid by Bega for Warrnambool was initially worth $319 million based on Bega's share price of $3.15. Now that its stock is at $3.61, the bid is worth $361m.

The food sector's momentum has been confirmed this month with our latest Quantitative Report.

Each month we screen the stocks we cover based on two momentum factors and one risk. In this month's report, four of the top 10 movers and shakers were food orientated.

In the past six months, shares in nutritional products provider Freedom Foods have more than doubled, while almond harvester Select Harvests' have climbed almost 70 per cent. Salmon producer Tassal's have increased about 52 per cent over the same period, and at current levels it still manages to deliver investors a dividend yield of 5 per cent.

These stocks are no longer cheap, and it is becoming clear that fund managers have been underestimating the food thematic, and are now racing to get on board. Investors are cottoning on to trends such as the insatiable demand for protein in China, growing dairy consumption, and the flavour-of-the-month brain foods such as nuts, as well as fatty acids such as Omega3, and gluten-free, allergen-free, taste-free foods, as well as anything organic. You name it in the name of healthy food, and people are buying it.

These investors include the fund managers who are chasing stock in Bega and Warrnambool, neither of which would not have been in many of their portfolios. They are aware that the combined entity will have annual revenues approaching $2 billion.

Investors clearly believe that Bega will generate more than the $7.5m synergies from the merger it claimed. As longtime agricultural sector watcher Paul Jensz of Phillip Capital says: "Bega is a group keen to get into the value-added part of dairy market, while Warrnambool is more of a commodity player. Eighty per cent of its product is raw ingredients it sells into the wholesale market. Bega will take Warrnambool's milk and get into more value-added product."

But we do not believe that investors are bidding the stocks up because of the potential for a competing offer for Warrnambool.

In late 2009, the dairy co-operative Murray Goulburn made a bid, but this was rejected due to competition issues. The co-op continued to hold on to its stake, and in fact increased it from 12 per cent to its current 16.6 per cent.

Agricultural stocks should generally trade at a discount to the market because of seasonal and weather-related risks involved. In recent years, with so much focus on miners and banks, and on the telecommunications giant Telstra, it is not surprising one of Australia's key industries has gone relatively unnoticed by big investors. Until now.

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