The new PM and your portfolio

Scott Morrison is likely to be more generous in the role

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A better than expected budget, a cheaper than expected pension system — and a former treasurer now running the country. Investors are suddenly reassessing what Scott Morrison's PM status might mean for portfolios and retirement plans.

Just this week we received an inkling of what might be coming down the line: Morrison as Prime Minister is a very different political operator than the man we watched as treasurer ... put simply, he is likely to be more generous.

But usefully for all investors he is across the national accounts better than almost anyone else — he knows where the trouble is buried and equally he knows where the opportunities may occur.

It's this direct experience in Treasury that allowed Morrison to announce midweek that he will reverse a plan that would have moved the retirement age to 70. (It moves from 65 and six months now to 67 over the next five years.)

Morrison the PM knew it would work well with the public, Morrison the ex-treasurer knew it was possible from Treasury data.

Specifically, Morrison knew that Treasury forecasts on the cost of the pension system were looking seriously wrong — the forecasts had suggested the pension system as a percentage of GDP would blow out to more than 4 per cent over the coming decades. But actual Treasury data today shows the cost of the pension system is falling — from 2.9 per cent of GDP to 2.7 per cent of GDP.

One of the reasons for this improvement is Morrison's own work in Treasury, where he managed a brace of key initiatives especially his cost-cutting in super: within six months last year the following moves were introduced:

- There were the severe (if complex) reductions to pension access that came in on January 1, 2017. It's worth remembering that 90,000 people were completely removed from the pension system as a direct result of that policy change, while about 140,000 more received reduced payments.
- Morrison then put through the considerably more high-profile reductions in superannuation contributions concessions that came in on July 1, 2017.
- At the same time we also got a first-time tax on retirement income in the form of the $1.6 million "cap" for wealthier retirees.

While the PM was revealing that the pension system costs less than we thought, his replacement as treasurer, Josh Frydenberg, was signalling that the federal budget was also on a better trajectory than many expected.

The GDP figures this week were the best for almost six years — the federal budget is currently forecast to return to surplus after July 1 next year but it could well be sooner.

As PM Morrison now presides over a system where the effects of his policies as treasurer are starting to play out, to date he has won respect but little support from private investors. Morrison's key attraction for investors is that he is not Bill Shorten.

Yet politically, the PM needs to do a lot more to distinguish himself from the ALP opposition leader and election favourite. For investors, Shorten offers a confronting agenda, particularly for property investors since restrictions on negative gearing and an effective lift in capital gains tax is certain to crimp returns. It is estimated that the impact of the combined policies would cut after-tax return in property by 25 per cent. There are also targeted — but severe — plans to hit franked dividends and family trusts.

Some investors will by trying already to offset a potential Shorten victory through changes to asset allocation. (See Will Hamilton's article today on what you can do now.)

But the majority of investors will wait and see what further surprises Morrison and Frydenberg may have in store in the months ahead.

There is lobbying already from welfare representative groups to review the severe cutbacks unleashed on the pension system last year. There is lobbying from industry and property groups on a range of taxes.

Faced with the widening appeal of union-backed industry super funds, there is pressure to find an alternative for investors who want to put their money elsewhere.

One answer to this predicament could be to open up the Future Fund to the wider public — a move that has been put forward by Frydenberg's mentor figure, Peter Costello, the current chairman of the Future Fund.

But perhaps the most glaring opportunity is to revive the SMSF sector. If the PM is offering concessions to the public in the form of an earlier retirement age than planned, then self-funded retirees are actually discriminated again once more — self-funded retirees don't want public welfare, they want a self-funded retirement.

Recent figures suggest this once flourishing sector is losing momentum: total assets of SMSFs only grew 6 per cent this year against 9 per cent for bigger funds. Moreover, SMSF establishments are slowing down as the sector struggles to deal with a string of negatives. The latest setback is the effective removal of an ability of SMSFs to borrow. Though the government has not formally terminated borrowing in super, advisers say it is virtually dead as one bank after another withdraws from the business.

Morrison's chance to reconnect with private investors comes in what will be a brief window between his ascension as prime minister and the next federal election — more than one million Australians with SMSFs have seen little but the stick from Morrison. It's time to throw some carrots at private investors.

I would like to diversify my self-managed super fund (SMSF) by investing in jewellery. Is this possible and what are the rules I would need to follow?

Jewellery is defined as a collectable under superannuation law. The rules that apply to "collectibles and personal use assets" owned by a SMSF apply to assets purchased on or after July 1, 2011. The definition of "collectibles" includes the following: artwork, jewellery (including gemstones), antiques, artefacts, coins, postage stamps, manuscripts or books, memorabilia, wine or spirits, cars and boats.

There are important restrictions that apply. The asset cannot be leased to a related party, it cannot be stored in a private residence of a related party (a member of the fund or related party), and it must be insured within seven days of acquisition in the SMSF's name. The asset cannot be used by a related party and if the asset is disposed of to a related party, it must occur at market price assessed by an independent valuer.

The law applies a set of rules of how you document ownership, prove the purchase, seek independent valuation and proof/recognition of ownership. Should you lease the asset to a third party, copies of arrangements when generating income and evidence of investment returns to the fund must to be kept. Likewise, evidence of expenses incurred for the costs of maintaining the assets. You need to affirm that super laws are satisfied, the investment complies with your fund's investment strategy and an independent valuation is obtained (at least every three years or when the asset is sold or transferred).

This is a complex area of investment for SMSF trustees and the penalties for making a mistake are severe. Given the complexity, trustees should seek expert advice and expect careful scrutiny by SMSF auditors and the Australian Taxation Office.

I am interested in investing in pink diamonds, possibly via my SMSF. Would this be a good investment?

Pink diamonds have received considerable media attention due to the record prices being attained for some stones at auction. As an investment asset class, the annual rate of return for the past 15 years has been reportedly in excess of 13 per cent. The key drivers of the price increase has been a combination of the demand and the scarcity of supply.

Western Australia's Argyle mine produces 90 per cent of the world pink diamonds. Less than 1 per cent of the diamonds mined from Argyle are pink, demonstrating the rarity. With the Argyle mine to close in 2021, investors are driving up the price of available stock.

Pink diamonds can be bought from a dealer or at auction. An entry-level investment-grade diamond will cost in the vicinity of $20,000. Like any collectable, the challenge is understanding if you are paying fair value. Whether it be from a dealer or an auction house, you should insist that the diamond is independently certified.

The auction or dealer fees to trade diamonds will range up to 10 per cent for both the buyer and the seller. Ongoing management costs may include secure storage, insurance and valuation.

Diamonds and collectibles are characterised as an "alternative investment". They should represent a relatively small portion of your investment portfolio. Like any investment, there are risks; prices may fall if buyer interest wanes or new sources of pink diamonds are found. You could lose or have your diamonds stolen.

Be wary of any advertising promising vast returns or focusing on past performance. Be wary of those promoting pink diamonds as being suitable for all investment portfolios or as a substitute for mainstream asset classes such as shares, property or bonds.

My view is that pink diamonds or any other collectibles should not be bought inside a SMSF.

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How to plan for the confronting tax reforms of a likely Labor government

WILL HAMILTON

Investors are increasingly apprehensive over a string of planned tax changes that will be introduced should the ALP win the next election as widely expected. There are several things an investor can do now to prepare.

I am not defending the proposed ALP tax changes in any way. I find them confronting. Unfortunately for the many who anticipate there will be a change in government, careful planning is going to be much needed.

Here are some ideas.

Regardless of which party is in power your success as an investor will be strongly linked to your portfolio structure. The first step to portfolio construction is asset location. For retirees this is simplified using superannuation in a tax-free environment up to the retiree's transfer balance cap.

The second step is asset allocation. If we were to see an ALP government and the abolition of cash rebates for retirees with franked dividends, this becomes more important than ever as many retirees have taken a simplistic approach to income and growth using domestic equities only.

The third step is to understand that asset allocation is a discipline. This is even more important as investors look towards income. Equity or risk allocations will need to be tiered towards growth and defensive allocations correspondingly to balance risk. The difficulty here is not to sacrifice balancing risk for income in an environment of low underlying returns, being careful not to substitute risk-based assets for income purposes.

Supporting companies reinvesting in growth opportunities is what equity investing is about. It is not about yield

If asset allocation is properly implemented, I would argue a retiree's portfolio should experience lower volatility due to the spread of assets and risk, as opposed to a large allocation to just domestic equities.

In this third phase, portfolio construction is also very important. Beta or passive investing has delivered in a declining interest rate environment however good active managers are continuing to deliver well above the benchmark.

Thoughtless or passive portfolio construction has done well in the low interest rate environment, hence the market has in many cases switched off to thoughtful portfolio construction. This is dangerous, and many will sleepwalk an investor into higher interest rates without knowing the implications. A good active manager should outperform in this environment. We believe active management in equities investing is definitely back.

Selecting a fund manager who looks at sustainable earnings should be the focus of company selection. Supporting companies paying out a lower percentage and reinvesting in growth opportunities is what equity investing is about. It is not about yield.

Investors might also make other portfolio considerations such as a greater asset allocation to foreign equities and global growth in areas you cannot gain exposure to in Australia. Reducing home bias and reducing an overweight to domestic equities is important as global markets can offer an investor exposure to areas of growth that are not available in Australia or at different stages of a cycle.

Balance is always about looking beyond pure domestic equities investment.

The first consideration is that the ALP has announced a plan to reduce the capital gains tax discount for assets purchased (and subsequently sold), from 50 per cent to 25 per cent. Therefore, if an investor assumes that the ALP will gain government, taking tax advice on CGT is the first step to minimise any potential impact.

If you are a retiree with a self-managed superannuation fund, and you are below the transfer balance cap of $1.6 million per member this does not have an impact since being in pension mode attracts a tax rate of zero. For those assets in an SMSF above the transfer balance cap, funds are taxed as an accumulation account, which is presently 15 per cent. The bigger impact is for investors with assets outside superannuation.

In the case of assets realised in your own name, these will attract a discount of 25 per cent instead of the old 50 per cent and personal marginal taxation rates will apply.

Those assets in a discretionary trust structure, as per the ALP proposals, will see a capital gain when distributed, attracting a minimum tax rate of 30 per cent in the hands of the beneficiary, regardless of the beneficiaries' marginal tax rate.

It is therefore crucial that investors thinking of disposing of assets bought after July 1, 2017 — and who are also concerned about CGT liabilities — seek tax advice and planning help.

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Results season 2018 - That's as good as it gets folks

ROGER MONTGOMERY

With the 2018 financial year reporting season complete, market participants have already moved on to thinking about a US-China trade war, the US mid-term elections and whether the plunging Turkish Lira associated with President Erdogan's increasingly authoritarian rule fuels emerging market contagion.

Sensible investors however know that the outcomes of these matters are rarely predictable and the market's reactions even less so. Instead, it is worth focusing on those issues that impact a company's business rather than its share price. Get the business performance right and the share price will look after itself.

With that in mind, the year's reporting season which is now effectively at an end, did offer some useful insights.

In my last column I referred to a theme that emerged early in reporting season; The combination of CBA warning of rising mortgage, credit card and personal loan arrears, Mortgage insurer Genworth reporting rising mortgage insurance delinquencies, power company AGL announcing a sharp jump in bad and doubtful debts and property group Mirvac slashing its expectations of residential lot sales, all pointed to financial stress on consumers and a negative 'wealth effect' from further property price declines.

Since those early reports however the rest of the results seasons appeared to suggest relatively benign conditions, and perhaps a reasonably resilient consumer. Investors also appear to be rather resilient. They pushed up the most expensive stocks even more during reporting season. In fact, the most expensive quartile of stocks at the beginning of 2018 has outperformed the cheapest quartile.

Some of that was clearly driven by Cochlear, which produced one of the most impressive results but the long-term potential and commitment to long term R&D is well known to the investment community suggesting the price is really now at risk of any disappointment or setback. Nevertheless it is clear investors remain willing to pay up for already expensive stocks.

Earnings per share grew by about 8 per cent on average. Excluding resource and financial companies, earnings per share grew closer to 11 per cent, which was generally better than expected.

But of course, all that is backward-looking. It is the outlook statements that provide a genuine insight into what to expect for business. On this score, according to our friends at UBS, negative 2019 revisions outweighed positive revisions by almost three-to-one, with the earnings estimates of stocks that reported revised down around one per cent.

Furthermore, almost two thirds of ASX 100 companies revised upwards their cost estimates.

Amid continued growth in discretionary spending, which I think will begin to taper, the retailers with strong brands and geographic footprints, like JB HiFi and Super Retail Group grew their market share.

Online sales also drove the majority of sales growth, albeit off a low base. For example, for the BCF and Rebel brands online sales growth drove almost all or the entirety of sales growth. Investors need to keep in mind that online sales offer lower margins and require long term investment – take it from someone who has invested in, built and sold a technology business.

Consumers and business also seem to be spending on travel. Flight Centre reported at the top end of its guidance and very strong international and online sales, emerging with lower costs, improved efficiencies and good growth prospects. Online rival Webject reported strong growth in corporate sales.

Perhaps most importantly however retailers with direct exposure to residential property reported softer economic conditions. The Reject Shop guided to flat first half 2019 net profit year on year, Harvey Norman referred to a highly competitive environment and tough consumer conditions, while Beacon Lighting and Nick Scali both reported tougher conditions ahead.

Given that housing activity, as measured by house sales, and renovation mortgage demand has slumped, it is a reasonable bet that demand for furniture, lighting, and household fixtures and fittings will slow as will demand for tools and materials required for renovating.

Overall, the 2018 results were relatively benign and there wasn't much evidence that consumers are pulling their heads in. But the canary in the coal mine has fallen off its perch suggesting 2019 earnings are likely to be revised lower in the not too distant future. Be warned and be prepared.

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