According to us newsletter

Winter 2016

Why Discretion is the Better Part of Valour (or the Argument for Holding Cash)

By Geoff Greetham, Executive Director

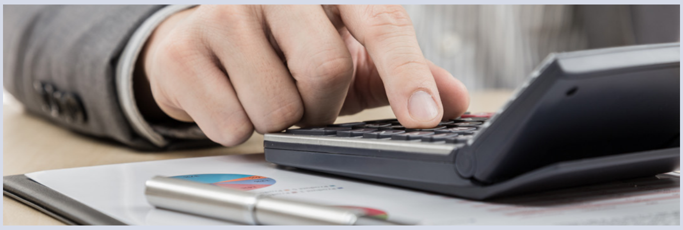
The famous Shakespearean quote uttered by the fictional character Falstaff in Henry IV Part 1, when feigning death at the hands of a Scotsman in order to stay alive, has resonance in the world of investments.

Often managers of people's money by virtue of their restrictive fund mandates are required to remain virtually fully invested at all times in asset classes like Australian Shares. Their ability to sit back and hold elevated levels of cash in search of opportunities for their clients is limited. Similarly a limit on cash holdings also requires them to be investing at times when the market on most valuation measures could be deemed expensive. Markets will inevitably fluctuate.

The flipside of this 'restriction' is there can be extended periods where share prices of companies might run ahead of what we deem reasonable valuations. Some might even receive takeover offers and rise exponentially as a result. FOMO (Fear of Missing Out) often pervades the market, with missing out translating into underperformance against the market index at these times.

That said, and as is often pointed out, the market index is an industry construct. It is there to assist managers for benchmarking purposes. Producing a negative return, for example, that still outperforms the index, whilst providing comfort to the fund manager, does not make you wealthy. Whilst it has relevance as a long term measure, at times it results in a wasteful short term focus, where prices become the measure of success as opposed to the fundamentals of a business such as its revenue, profits etc.

Our preference at these times is the safety of cash, with this flexible approach part of the process of long term investing, which means maintaining liquidity to survive and capitalise on periodic market dislocations as they arise (Brexit being a recent example, where we took the opportunity to buy).



We believe it to be better to have a 2% return on cash than being forced to invest in your 50th ranked opportunity, remembering that if the latter loses money the gain needed to recoup such a loss is proportionately more (refer below)

Loss	Gain Required to Recoup Loss
10%	11%
20%	25%
30%	43%
40%	67%
50%	100%

One criticism of holding elevated levels of cash which is levelled at fund managers is that 'I don't pay them to do something I could do myself' i.e. hold cash. It should be said most managers would like to be fully invested. It is the nature of the beast. But a fund manager should not only be there to identify undervalued/ underappreciated companies for you but also should be in a better position to know when the market, in terms of the valuation cycle, is cheap or expensive. I trust you would prefer your fund manager to manage your assets mindful of this rather than being compelled to buy stocks just because prices are 'going up'. A false sense of security if ever there was one.

As custodians of our clients' wealth, we prefer to invest in a methodical business-like way, based on tried and tested principles and a repeatable process, where the operational performance of the company is at the core. It doesn't mean we won't get some calls wrong. But is also means we won't be placing bets in the market akin to a casino. As custodians, we probably exercise greater caution, knowing that as painful as FOMO might be short term, an actual loss is felt more acutely long term.

Our focus always remains on generating real rates of return i.e. after inflation over the longer term through market cycles but in the process minimising the downside, mindful of preserving capital as much as possible. Real return can be as much about limiting such 'drawdowns of capital' than it is about finding those quality opportunities to grow your wealth.

Whilst we have faith in markets generating growth over the long term, we are unapologetic about holding cash when deemed fit. We suspect also you would only want us to invest with conviction.

In our eyes, Falstaff's words ring true.

Family Trusts – The ‘New’ Black

By Jackie Cook, Financial Strategist

Wealth accumulators have become increasingly alarmed by the seemingly constant tinkering of the superannuation system leading many to consider other alternatives. Moreover, there are some investors who have no choice but to explore other options following the recent Federal Budget announcement proposing a $500,000 lifetime non-concessional contribution cap to superannuation, which has caused much furore.

Whilst there has been much speculation surrounding this proposed lifetime cap, with the general consensus being that the terms of this cap are likely to be ‘watered down’ prior to legislation (e.g. commence from Budget night as opposed to the proposed 1 July 2007 commencement date), a lifetime cap, in any form, is likely to result in alternatives being required, particularly in the event of an inheritance or downsizing of a property.

Given this, we foresee an increasing demand from clients seeking advice about investment strategies that are effective alternatives to superannuation (or that may sit beside a superannuation strategy). One of which readily comes to mind is a family trust.

What is it and what are the benefits?

The term family trust refers to a discretionary trust set up to hold a family’s assets or to conduct a family business. Generally speaking, family trusts are established for the following purposes:

- **Asset Protection:** assists in protecting the family’s assets where one or more members become bankrupt or insolvent, as family members do not actually own the trust assets.
- **Tax:** allows income to be distributed to family members with lower tax rates (e.g. a non-working spouse or children over 18 who are still studying).
- **Flexibility:** provides scope to alter trust distributions among the beneficiaries in whichever way the trustee chooses (providing the distributions accord with the trust deed and the law generally).
- **Estate Planning:** offers greater certainty about how assets will be managed after death, without triggering a tax event.

Furthermore, when compared to superannuation, there is no need to wait until retirement age before you can access your funds.

How does it reduce tax?

To provide an example of how this strategy would work in practice, consider a couple earning $100,000 each with two dependent children (aged 21 and 19).

The 21-year-old works part-time while studying and earns $10,000 a year. The other child does not earn any income and is a full time university student.

The couple hold $500,000 worth of investments. During the year, these investments generated a net return of 5%, resulting in taxable income of $25,000.

If the couple were to hold these investments in their own names, they would pay 39% (their marginal tax rate plus Medicare Levy) on the full $25,000, which would result in tax payable of around $9,750.

Alternatively, if the investments were held in a family trust and distributed $18,200 (the tax free threshold) to the 19-year-old and $6,800 to the 21-year-old (keeping them under the tax free threshold), there would be no tax payable on the taxable income generated within the trust.

By distributing the funds in the most tax advantageous manner, the amount of tax the family pays is reduced from $9,750 to $0.

Who are the players?

There are four roles that need to be fulfilled when establishing a family trust:

- **The Settlor:** the person who creates the trust by ‘settling’ a sum of money or item of property on trust for the beneficiaries.
- **The Trustee:** the legal owner of the trust property (although not the beneficial owner). This is usually the husband and/or wife, or, in the case of a corporate trustee, the company of which the husband and/or wife are directors. The trustee carries out all transactions of the trust in its own name and must sign all documents for and on behalf of the trust. The trustee’s overriding duty is to obey the terms of the trust deed and to act in the best interests of the beneficiaries.
- **The Appointor:** the person named in the Trust Deed who has the power to remove and appoint trustees. This would commonly occur when the trustee dies, becomes bankrupt or is incapacitated; or, in the case of a corporate trustee, when the company is wound up.
- **The Beneficiaries:** the people for whose benefit the trustee holds the trust property. In the case of family trusts, it usually includes the husband, wife, their children and other lineal descendants.

While superannuation is still the pre-eminent vehicle for saving, family trusts are likely to garner more attention going forward. However, like superannuation, strategic advice is important to determine the appropriateness for one’s circumstances.

If you (or anyone you know) are interested in exploring this further, please contact our office to arrange an appointment.

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Did you know....

Global bond yields are their lowest in 500 years.

According to one report, of $37 trillion invested in developed market government bonds globally at present, 80% have a yield below 1%. Incredibly, over $15 trillion (or 41% of this total) of government bonds trade at yields ‘less than zero’ as of June 30th!

In other words, you are lending money to governments like Germany in the knowledge you will get less back.

We live in interesting times.

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Accordius Pty Ltd • ACN: 128 900 603 • AFS Licence No. 321955
Level 24, 333 Collins Street, Melbourne, VIC 3000 • GPO Box 2985, Melbourne, VIC 3001
Telephone: +61 3 8623 3378 • Fax: +61 3 8678 1235 • Email: information@accordius.com.au

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