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This Week's Top Articles

The economic reality of breeding and owning racehorses

Garry Mackrell

Australia is unique in the thoroughbred racing world in that ownership of horses is spread across a broad spectrum of Australians and is not just the province of royalty, the rich and famous. Indeed, there are some 100,000 owners or part-owners in Australia. Australia holds the second largest number of races per annum in the world after the U.S. and allocates the third most prize money (in excess of $500 million per annum) after the U.S. and Japan.

There are about 360 race tracks in this country. Each year there are 36,000 racehorses (excluding steeplechasers and hurdlers) of which 30,000 are race starters racing on average six times a year at over 2,700 race meetings. So there is plenty of opportunity to be a participant and, you would think, be a profitable player somewhere in the value chain.

Before you jump in and decide a portion of your hard-earned could be invested in a Group 1 winner, maybe the Melbourne Cup, or even more profitably to breed and race a colt who wins the Golden Slipper and goes on to fantastic success as a stallion, let me provide a few insights which provide a reality check on your dreams of fame and fortune.

To attempt this in a short discourse I will necessarily restrict comment to some key statistics that drive the economics of the business, and some aspects of how to view risk and return in the main elements of the racehorse value chain.

(For the uninitiated, a male horse is born as a colt, and at four years old, becomes an 'entire', or a stallion if he goes to stud. A female horse is born as a filly, and becomes a mare at four years old).

Industry and participant drivers

Prize money is rising steadily over time and although some major races are being allocated ever-more generous amounts, it is also being spread across regional and country race meetings.

Of the $500 million in prize money, $140 million goes to the 580 so-called 'black type' races, of which 72 are Group 1 races attracting nearly $70 million. Prize money for Saturday races in the major Eastern State cities ranges from around $40,000 to $85,000, mid-week city around $20,000 to $40,000, down to $10,000 to $30,000 for regional and country meetings. Prizes are skewed strongly to winners, falling to modest amounts if the horse runs 5th.

However, the numbers of horses being bred and raced is, somewhat surprisingly, falling steadily over time. Horses bred have fallen by a third over the past two decades; the breeding mare population is now around 23,000 of which 21,000 are mated. Although foal success rates have improved somewhat, the number of foals born is 14,000 a year. The number who go on to race have to be registered and in 2013/14, this was over 12,000, of which 9,000 were registered by age two, around 2,500 by age three and the balance (900) older. The number of foals sold at auction was around 4,000, with the surprisingly larger balance retained by breeders and owners for racing or breeding.

Even more starkly, the number of registered stallions has fallen over the past two decades from 2,090 to 670. Only about 100 might be regarded as significant players, of which 40 shuttle between Australia and northern hemisphere countries.

In 2013/14, of the 30,000 race starters:

- 4,200 did not earn any prize money
- 15,000 earned $1,000 to $10,000
- 10,200 earned $10,000 to $100,000
- 700 earned $100,000 to $500,000
- 50 earned greater than $500,000.

The bulk in each category, especially the larger amounts, were at the lower end of the distribution range. In earning these amounts:

- 18,000+ did not win a race in the year
- 7,000+ won one race
- 3,000+ won two races
- less than 2,000 won three or more races.

The ages of these horses ranged from nearly 3,000 running before age three, just under 8,000 each for under four and five, 5,500 under six and around 6,000 above six.

The above clearly demonstrates winners, and especially winners of valuable races, are very much in the minority and their time in the racing headlines, unless a tough, durable stayer, is around three or four years. Being the highly-refined athletes they are, they need a good deal of time to first learn the whole process of what racing is about, then achieving and retaining race fitness.

There will also be times they are injured. If healthy, they generally have two or three race campaigns a year where the aim is to run four to seven times and more as the horse matures with each campaign. Many never race for a wide variety of reasons.

The economics of racehorses

To appreciate why racehorse numbers are falling necessitates an examination of the micro economics of racing. While the purchase price of a yearling (the most common entry point for buyers) varies enormously from a few thousand dollars to occasionally in multiples of millions, studies around the world suggest the most profitable racehorses tend to cost between $70,000 and $250,000. The average sale price of yearlings sold in 2013/14 was $70,000, with the median at $35,000.

The intending buyer has the obvious choice of buying a filly or a colt. There is a positive bias in the price of colts, especially those with athleticism, pedigrees, conformations (correctness of bone structure), sound X-rays and dispositions which, if successful runners, may ultimately lead to them being stallion candidates. However, as seen above, the realisation of this dream applies to well under 1% of the racing population.

Conversely, a sound gelding can have a materially longer career. Fillies with similar attributes are also in demand, but generally their racing careers stop at ages of four to five years.

Our analysis, therefore, needs to distinguish between time in racing and the potential residual value a horse retains when it ceases racing. While there are material differences in purchase prices and later, nomination fees for horses running in the big prize money races, the actual costs of racing a horse are reasonably standard.

Assuming a horse costs $100,000, the aim is to progress from regional tracks to mid-week and then Saturday metropolitan class races and above. Budget to spend around $40,000 to $50,000 from purchase date to the time it first runs. In addition, there will be around $25,000 to $45,000 per annum in training fees, spelling charges, vets, farrier and chiropractic services, transport etc, depending on whether the trainer is city or country based. If you own a percentage of a horse, the above costs break down in the same proportion.

As a rough rule of thumb, if a horse can generate prize money of an average of $5,000 per race, implying sound regional and possibly mid-week city class, it is a horse which covers both its costs and has a good chance of paying back the purchase price. Earning an average of $10,000 per race is a

Saturday city class horse and, if it stays sound, may double the initial investment. At $20,000 average per race, the horse is a probable 'black type', and $50,000 per race is exceptional and fortunate.

The probabilities of having a horse that fits each particular earning category is something I guesstimate as around 15-20%, 8-10%, 4% and 1% respectively of the population. Profitable investment is highly skewed to outliers.

When investing in most other asset classes (property, shares etc), the most you can lose is your principal. Unless you are disciplined and are prepared to cut your losses early, if you persist in racing your horse without success, you will ultimately lose a lot more than your principal. Even if you make an early call, and especially if you have a slow gelding or an average-looking mare whose family is not progressing, the selling price might well be less than $10,000, often for country trainers to try their luck in weaker company.

With these considerations in mind, the market is becoming more highly bifurcated - horses with the athletic carriage, looks, pedigree etc are being increasingly sought after, whereas the greater population of more unimposing and average pedigree are increasingly lacking appeal.

It doesn't mean the latter can't be successful. It is a game of probabilities but buying prices are fundamentally driven by buyers' imaginations of future glories for their glamorous purchase, including the potential residual value after racing. Regrettably, buying a piece of a $1 million colt is also no guarantee of success. Equally frustrating, if you happen to have a champion racehorse mare, history shows such mares don't always prove to be as successful as broodmares.

The obvious insight here is that returns from investing in racehorses are not normally distributed like most other asset classes. Buying a portfolio of 'average' horses will most likely result in significant losses. The search is for the few valuable outliers to pay for the rest (even here there will be significant volatility of returns from year to year).

Types of racehorse buyers

How racehorse buyers approach this lop-sided skew is significantly influenced by which group they come from, including:

- wealthy individuals who are prepared to outlay large sums of money essentially in the pursuit of glory
- large horse studs which are focussed on breeding and acquiring their future champion stallion and broodmare lines which sustain their businesses
- family and other more boutique studs aiming for reliable broodmare lists
- famous trainers, ranging from those who have up to 180 horses in their stables, down to the country trainer with a handful of horses, all of whom have loyal clients with widely-ranging amounts of funds to outlay and who are repeat buyers of shares in the trainer's selections
- race syndication groups, where in order to avoid the impracticality of having to offer a prospectus, ASIC provides exemptions for racehorses purchased by 10 or fewer legal entities and 40 or fewer owners of a stallion. The target price range for the syndication groups tends to be $50,000 to $150,000.

The spread of ownership tends to be more widely distributed where the primary motivation is buying to race. Where the ownership is spread, after their race careers are finished, race mares are then sold privately or via public auction to the various breeding groups to dissolve the partnerships.

Residual value considerations

When investing in racehorses, due consideration needs to be given to whether the horse will have residual value after it ceases running. A stunning colt with an outstanding pedigree and key Group 1 wins can attract bids from the big stallion studs of $10 million to $30 million. Likewise, an outstanding mare with the right family and strong 'black type' race record can also attract $500,000-$1 million plus on sale.

A colt has a 99% chance it will ultimately be gelded to improve tractability (manageability) and behaviour, keep its weight under control and generally extend its potential race career. After racing, geldings are virtually giveaways to people who want hacks.

For stallions, first year stud fees are pitched at what the stud manager judges the market will bear.

Recently, fees have ranged up to $60,000 per 'service' but generally around half this or lower. Once the stallion's progeny start racing, fees will quickly skew materially as results start to flow, to upwards of $100,000 or drift back to $10,000 to $20,000 as experience and new sexier entrants emerge. With 150 to 220 matings possible in a domestic season and a possible northern hemisphere season as well, a successful stallion's career can extend until they are over 20 years old, and be highly profitable to the owners.

A filly's potential value for breeding after racing will be driven by her general looks and conformation (musculature, body proportions, bone structure, etc), her race record and that of her immediate family. However, this potential value will only be known after probably her third or fourth foal has been racing for a year or two, or five to six years later!

In the interim, if you select the right stallions and the filly produces attractive foals, the market will be prepared to pay a premium for her progeny, until race results come through and her then remaining residual value will move strongly up or down.

The productive life of a mare can extend until their early 20s, and if fertile and has few misses, can produce as many as 15 foals. The average is probably eight to 10. Pregnancies run for 11 months and 10 days, so you get one foal a year, with a likelihood of the mare not being mated for various reasons every four to six years. The most successful progeny tend to be the first four foals, but keen buying interest will be sustained if one or more of these early foals win 'black type' races.

Assuming you buy a mare for $100,000, and pay $30,000 for the stud fee, you can expect to pay an additional $30,000 to $40,000 for the foal by the time the foal is sold as a yearling. So, to recover the investment in your mare you need to average $100,000 for the first three foals ie payback takes five years plus.

Again, experience shows that in addition to a number of mares in your portfolio not falling pregnant, occasionally the mare will lose the unborn foal, or it will be stillborn. More frequently, the foal can be lacking in stature, or has conformation or X-ray issues with their legs. A mature horse weighs around 500 kilograms. Horses with deficiencies in their bones or the way they move will be much more likely to break down when racing and some features can be genetically transmitted, so as a consequence, will be severely marked down by buyers.

The probability of a stream of yearlings from the same mare which attract keen buying interest every year is low. The prices fetched for a portfolio of mares have a similar skew to racehorse performance: a few stars overcompensate for the rest.

The large studs with their greater numbers and ready access to their own stallions can spread their overheads and steadily build the depth and consistency of their broodmare lines via their portfolio strategies. The smaller broodmare studs have greater year to year variability of returns.

The need for investors to recover the cost of their outlays as soon as practicable has driven the Australian thoroughbred industry relentlessly towards breeding sprinters, primarily because these types mature earlier and hence race earlier.

Ironically, some races which attract the biggest prize money are staying races such as the Classic Oaks/Derbies, Cox Plate and Caulfield and Melbourne Cups. Stayer-type stallions are not in vogue. Indeed, the stocks of local stayers is so threadbare that investors have been trundling off to Europe in droves to find staying-types who might do well under Australian conditions and tactics. Buying a partly-tried stayer has much faster payback potential than having to wait for your yearling to be four or even five before it runs.

Limit outlays while learning the game

Investing in racehorses is not for the faint-hearted, especially if you really cannot afford the losses and the associated ongoing costs of racing or breeding. If your primary interest is the general thrill of being a participant, budget for the potential losses and regard this as your entertainment spending.

If you see the industry as a potential high risk but also high return possibility, then you have to be clear as to how you propose to approach the risk and high failure rates. I have made comment about the outlier nature of the profit skew. Investors endeavour to address this by investing in smallish shares of a portfolio of horses. Small shares in more expensive horses are more likely to give a more balanced risk/reward outcome than owning outright one or two cheaper punts.

While luck does play a critical role, the luckier ones seem to be those who have been in the game for long periods and have learned the hard way what is more likely to be a good horse. Black Caviar raced and won 25 times - she won most by several lengths, but in reality she often won by less than a second or two. So the difference between a champion and an also ran is very small.

To have the best you must associate yourself with the best. Before plunging in, find out who (trainers, bloodstock agents, syndicators) have earned the market's respect for their judgments, what their modus operandi are, and limit your outlays until you better understand the game.

Garry Mackrell is a former member of the Executive Committee of the Commonwealth Bank, now 'retired' and an optimistic mare stud owner as the proprietor of Bell View Park Stud. Most of the broad statistics quoted in this article are derived from The 2013/14 Australian Racing Fact Book.

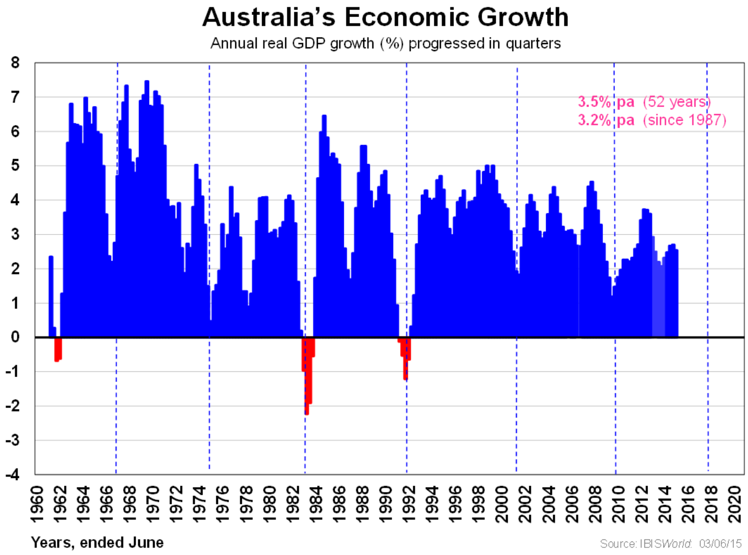
Are recessions a thing of the past?

Phil Ruthven

Australia hasn't had a recession for almost a quarter of a century, so are they a thing of the past? The word 'recession' connotes fear for those that have been through one, being less than half today's workforce. The word 'depression' suggests terror for those that went through the last one in the 1930's as a worker, being 31,000 Australians, or just 0.13% of the population.

A recession occurs when we have two or more quarters of negative economic growth, usually converting to a negative year overall. A depression occurs when we have two or more negative years, usually four in a row for Australia.

Fortunately, we have had only four depressions in 227 years, the last one ending over 80 years ago in the 1930s. And we have fewer recessions than in the Industrial Age - when we had 20 of them over a 100 year period or one every five years on average - but only two over the past 50 years since the new Infotronics Age began in 1965. The last one was 23 years ago, ending in 1992 as shown in the exhibit.



Avoiding complacency setting in

Half today's workforce of 11.8 million has never experienced a recession in their working lifetime. It carries the risk of the *boiling-frog* syndrome whereby complacency sets in, productivity growth slows, deficit spending becomes a habit, workplace reforms are put off, and unemployment rises. This is Australia today, and Greece is an extreme example over a much longer period: two generations at least, and now a classic *basket-case,* as they say.

Strangely, we may be better to have another one sooner rather than later to correct the above drift, notwithstanding we have a very low national debt and a relatively modern economy. A lot of things need to be done, as the list below suggests. There are not enough 'yesses'.

Government Initiatives: are they being addressed?

(Yes/No)

1.	**Balanced budgets**, the first rule of good government	No
2.	**Tax reform** that includes GST and shifts taxes to spending	Yes/No
3.	**IR reform** that understands work and workers in the New Age	No
4.	**Innovation, IP and productivity**; and how to get them.	No
5.	**Fully embrace the digital era** for international competitiveness	No
6.	**Long range vision**, especially our role in the Asia Pacific region	Yes/No
7.	**Reduce subsidies** going to yesterday's industries that won't survive	Yes
8.	**Privatization** of low-productivity government activities.	Yes/No
9.	**Rational energy policy** that includes carbon, nuclear power.	No
10.	**Developing the top part of our continent** (especially top ⅓)	Yes/No

The nation has had reform paralysis for much too long, and that is dangerous given our new economic and social homeland of Asia: the biggest, most dynamic and fastest growing region of the world, where we will be trading and competing for a century or more.

We need workplace reform, involving penalty rates, contractualism (to reward on outputs not inputs), more worker freedom and flexibility.

We need reform: in our parliament (Senate election protocols); in our Federal budgeting (the deficit habit); in our taxes (GST in particular); in our negative productivity in government-owned activities (22% of the nation's GDP); in our society (more fairness, but also more self-reliance); in our energy policy area, and more.

However, while all these issues are important to our rising standard of living - indeed critical over the longer term - the cause of recessions lies elsewhere.

Potential causes of recession

Markets pull the economy (GDP) along, not production. There are three major sectors in the marketplace:

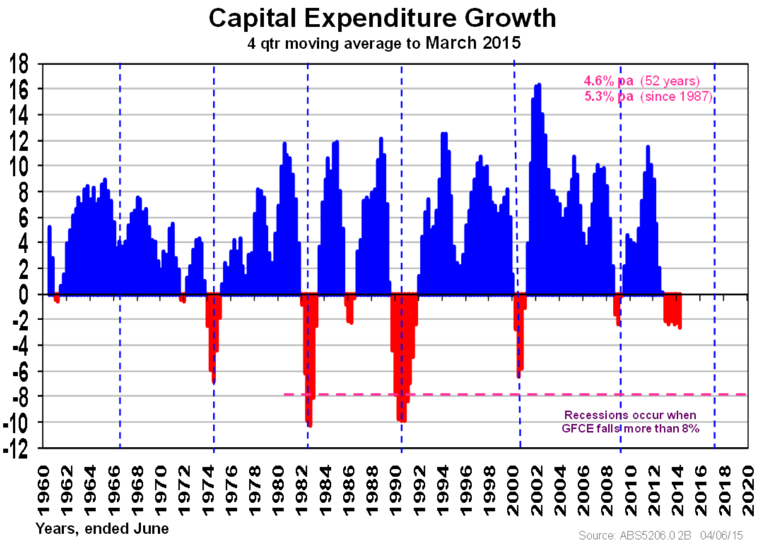
- overseas expenditure (our exports)
- consumption expenditure (households and government on our behalf)
- capital expenditure.

Exports do go negative in growth but rarely, and even those occasions have not been severe enough to trigger a recession over the past 50 years.

Consumption expenditure has not gone negative since World War II, so has never caused a recession in the lifetime of most Australians unless they are well over 75 years of age. One of the factors that has helped keep consumer spending in the positive zone is the dominance of services in household spending. Goods once consumed over two-thirds of household budgets a century ago. Now, only a fifth is due to manufacturing productivity and - more recently - cheaper imports.

Indeed, in 2013, household spending on outsourced chores and services exceeded retail goods spending for the first time in history. Consumers are less likely to stop or curtail spending on services than goods, especially durables. They will still pay for electricity, insurance, health, education and even entertainment of one form or another. The facts show this to be true over the past six or more decades.

That leaves the only market sector that can cause recessions: *capital expenditure*. The two recessions we have had in this new age were caused by a collapse of more than 8% in a given year. This happened in the 1982-83 and 1991-92 recessions, as seen in the following exhibit.



Dotted lines are shown around every 8½ years on average. This is what economists term the long business cycle. It is at the end of each of these periods when our economy is susceptible or vulnerable to a collapse in capital expenditure. It was in 2000-01, but averted by the Howard/Costello initiative in housing construction with the First Home Buyers Grant, doubled in the following year to make sure a recession was averted! We missed a recession in 2008-09 too, due to the massive backlog of mining capital expenditure.

The Rudd initiative of pink batts and give-away money in two tranches to households was not necessary, and a panic reaction. We didn't need any bolstering of consumer spending. Mortgage rates had collapsed from 9.25% to 5.25% from 2008 and petrol price rises had fallen sharply, enough to free up over $10,000 in after-tax money for the majority of households! Better to suggest they spend some of it rather than give them more, and at the same time let the public know we were not going to experience a GFC as we had no national debt.

But the looming risk of a recession in 2017-18 at the end of the current long business cycle is very real this time. Over 25% of our capital expenditure (itself

28% of GDP) was going to the mining boom until recently. At least half of this or more will have gone by 2018, so filling that hole is the challenge in avoiding a recession. Governments are largely aware of this risk, hence the drive into more infrastructure spending.

We have a couple of years to fill this hole, otherwise a probable recession is in train. But in the absence of serious reform vision, initiatives and courage, it may not be a bad thing if we had one to shake us out of lethargy. Another one 'we had to have', so to speak.

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Even Warren Buffett has evolved from Ben Graham

Roger Montgomery

Ben Graham is regarded as the intellectual Dean of Wall Street. He literally invented equity security analysis at a time where bonds were all the rage, and a couple of his mantras have stood the test of time. His 'Mr Market' allegory is of course a brilliant retort to the efficient market theories on which an entire generation has based their trust through index funds. And it's his idea that the three most important words for an investor are 'Margin of Safety'.

Interestingly, however, if Ben Graham had access to a computer back in the 1930s and 1940s, I suspect he might not have reached some of his other conclusions.

Whilst many investors use Ben Graham's models for intrinsic value to evaluate the attractiveness of companies, we don't. Let me explain why.

Moving on from Ben Graham

First, though, I am a little nervous about publishing an article advocating against a strict Graham-approach, as it may put a few noses out of joint. So I have referenced what I believe to be the pertinent quotes that have reinforced my conclusion that value investors should move on from many parts of Graham's framework.

In the 1940s, Ben Graham (who passed away in 1976) "was one of the most successful and best known money managers in the country." (quoted in the book, *Damn Right,* by Janet Low, page 75). In 1949, an eager Warren Buffett read Graham's book *The Intelligent Investor* and the rest, as they say, is history.

Warren Buffett regards Graham's book *Security Analysis* as the best text on investing, regularly referring investors to it and his other seminal work, *The Intelligent Investor*. One of my favourite Graham publications is *The Interpretation of Financial Statements*.

It might surprise many value investing students to know that, thanks to his long time partner at Berkshire Hathaway, Charlie Munger, Buffett has moved far from the original techniques taught by Graham. Ben Graham advocated a mostly, if not purely, quantitative approach to finding bargains. He sought to buy businesses trading at a discount to net current asset values – what has been subsequently referred to as 'net-nets'. That is, he sought companies whose shares could be purchased for less than the current assets – the cash, inventory and receivables – of the company, minus all the liabilities.

Graham felt that talking to management was sort of cheating because smaller investors didn't have the same opportunity. Whilst the method had been very successful for Graham and the students who continued in his tradition, people like Warren Buffet, Walter Schloss, and Tom Knapp, Graham's ignorance of the quality of the business and its future prospects did not impress Charlie Munger. Munger thought a lot of Graham's precepts "were just madness", as "they ignored relevant facts" (also quoted in *Damn Right*, page 77)

So while Munger agreed with Graham's basic premise – that when buying and selling one should be motivated by reference to intrinsic value rather than price momentum - he also noted "Ben Graham had blind spots; he had too low of an appreciation of the fact that some businesses were worth paying big premiums for" and "the trick is to get more quality than you pay for in price." (*Damn Right*, page 78)

When Munger referred to quality, he was likely referring to the now common belief held by many sophisticated investors that an assessment of the strategic position of a company is essential to a proper estimation of its value.

In 1972, with Munger's help, Buffett left behind the strict adherence to buying businesses at prices below net current assets, when, through a company called Blue Chip Stamps, they paid three times book value for See's Candies. Buffett noted; "Charlie shoved me in the direction of not just buying bargains, as Ben Graham had taught me. This was the real impact he had on me. It took a powerful force to move me on from Graham's limiting view. It was the power of Charlie's mind. He expanded my horizons". Furthermore, "… My guess is the last big time to do it Ben's way was in '73 or '74, when you could have done it quite easily." (Robert Lezner, 'Warren Buffett's Idea of Heaven', Forbes 400, 18 October 1993, page 40).

So Buffett eventually came around, and the final confirmation that a superior method of value investing exists was this from Buffett: "Boy, if I had listened only to Ben, would I ever be a lot poorer." (Carol J. Loomis, 'The Inside Story of Warren Buffett', Fortune, 11 April 1988, page 26).

Investing techniques evolve

Times in the United States were of course changing as well, and it is vital for investors to realise that the world's best, those who have been in the business of investing for many decades, do indeed need to evolve. In the first part of the twentieth century, industrial manufacturing companies, for example, in steel and textiles, dominated the United States. These businesses were loaded with property, plant and equipment – hard assets. An investor could value these businesses based on what a trade buyer might pay for the entire business or just the assets, and from there, determine if the stock market was doing anything foolish.

But somewhere between the 1960s and the 1980s, many retail and service businesses emerged that had fewer hard or tangible assets. Their value was in their brands and mastheads, their reach, distribution networks or systems. They leased property rather than bought it. And so it became much more difficult to find businesses whose market capitalisation was lower than the book value of the business, let alone the liquidating value or net current assets. The profits of these companies were being generated by intangible assets and the hard assets were less relevant.

To stay world-beating, the investor had to evolve. Buffet again: "I evolved … I didn't go from ape to human or human to ape in a nice, even manner." (L.J. Davis, 'Buffett Takes Stock', New York Times Magazine, 1 April 1990, page 61).

Many investors cling to the Graham approach to investing even though some, if not many of his brightest and most successful students, moved on decades ago.

If you want to adopt a value-investing approach, there is no doubt in my mind that your search for solutions will take you into an examination of the traditional Graham application of value investing. It is my hope, however, that these words will serve as a guide towards something more relevant, and whilst unable to be guaranteed, more profitable.

If you have tried to adopt the Graham approach and had some success, well done. Now move on.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any investor.

Study the pension reforms with great care

Rachel Lane

It is easy to see why people have been calling for the inclusion of the family home in the pension assets test. Why should someone who lives in a $2 million home receive the full pension? But the government has backed down and is now changing the asset test taper. These changes are designed to reduce the entitlement of part-pensioners, but will also hit 'downsizers' and people moving into aged care hard.

Under the current asset test a person (or a couple) lose $1.50 per fortnight of age pension for every $1,000 of assets they have in excess of the asset test threshold. The proposed changes will increase the maximum amount of pension (expected to be $30 per fortnight for a single) and the asset test threshold before their pension starts to reduce. There will also be an increase to the rate at which the pension reduces, from $1.50 per fortnight to $3 per fortnight. If you think you are suffering *déjà vu* that's because prior to the asset test changes in 2007, the asset test taper was $3 per $1,000 of assets per fortnight – yes, back to the future!

Here's a snapshot of the changes to the asset test:

Single Homeowner NOW	Single Homeowner 2017	Single Non-Homeowner NOW	Single Non-Homeowner 2017
Asset Test Threshold			
$205,500	$250,000	$354,500	$450,000
Asset Test Cut Off			
$779,000	$547,000	$928,000	$747,000
Couple Homeowner NOW	**Couple Homeowner 2017**	**Couple Non-Homeowner NOW**	**Couple Non-Homeowner 2017**
Asset Test Threshold			
$291,500	$375,000	$440,500	$450,000
Asset Test Cut Off			
$1,156,500	$823,000	$1,305,500	$1,023,000

Watch the income test as well

The government estimates that 230,000 pensioners will lose some or all of their pension while 170,000 pensioners will receive more. Of course, the pension paid is based on both an asset test and an income test, with the test that produces the lowest amount of pension being the amount paid. Little attention is being given to the income test, to which my warning to pensioners would be ignore it at your peril! The income test often bites people before the asset test does, especially when the majority of someone's assets is held in financial investments such as bank accounts, term deposits and shares and not holiday homes, boats, caravans or cars.

A single pensioner with $240,000 in the bank and a car and personal effects worth $10,000 may be entitled to the full pension under the new asset test, but under the income test their pension would still be reduced by $55 per fortnight.

For those who benefit from the changes, the joy may be short-lived if they choose to downsize to a retirement village or need to move to an aged care facility. This is because most people pay less than the value of their home. Under these changes they may be better off paying an amount that is equal to or greater than the value of their current home.

In a retirement community this may be a lot simpler. Some retirement communities will allow you to pay a higher amount going in and pay a lower amount as an exit fee. For people moving into aged care it is not so simple. The aged care reforms that were introduced on 1 July last year mean that residents cannot pay more than the market price. Adding to the complexity, downsizers who move to an Over 55's community rather than a retirement village may find that it is more affordable due to the ability to access rent assistance and the fact that exit fees often don't apply.

Let's look at an example. Betty is a part pensioner who is considering moving from her family home to a retirement village. Her home is worth $650,000 and the unit in the retirement village is $400,000. Betty has $100,000 in the bank, $150,000 in term deposits and $10,000 worth of personal effects including her car.

Betty currently receives $778 per fortnight (pfn) of age pension. If she remains at home the changes would increase Betty's pension to around $860 pfn under the asset test but under the income test Betty would only be entitled to $829 pfn.

If Betty moves to a retirement village, and pays $400,000 for her unit, the extra $250,000 in assets will reduce her pension to only $110 pfn. Put simply, she loses $780 pfn of pension.

If Betty purchased a unit in an Over 55's community for the same amount, her pension would still be $110 pfn but she could receive rent assistance of up to $128 pfn. This is because in an over 55's community, you own the home but rent the land.

Conversely, if Betty chose a more expensive retirement community, say $700,000, she would be $40,000 below the new asset threshold and entitled to $890 pfn. But her pension would only increase to around $860 pfn due to the income test. If the unit was in an Over 55's community her pension would be $860 pfn and she could receive up to $128 pfn of rent assistance.

If instead Betty moves to an aged care facility and pays $400,000 her pension would be $710 pfn because she has the benefit of the non-homeowner asset threshold. If she chose a facility with a market price of $700,000, her pension would be $860pfn again due to the income test.

Downsizer's have more choices around the price they pay and when they move. People needing aged care are limited by the market price arrangements introduced in July 2014 as well as the need to access care. Placing such a disincentive on downsizers and people who need care does not serve senior Australians or the young people who miss out on the opportunity to buy a home.

Rachel Lane is the Principal of Aged Care Gurus and oversees a national network of financial advisers. Read more about aged care facilities in the book 'Aged Care, Who Cares; Where, How and How Much' by Rachel Lane and Noel Whittaker. This article is for general educational purposes and does not address anyone's specific needs.

The benefits of low turnover for after-tax outcomes

David Bassanese

The tax efficiency of some managed funds and exchange traded funds (ETFs) is often an underappreciated and less visible benefit for investors. In Australia, fund manager performance is most often assessed on pre-tax returns. A low portfolio turnover can potentially provide significantly better after-tax returns relative to that of a high turnover actively managed fund, assuming all other factors are equal. For broad Australian equities exposure, we provide an illustration of how a low turnover structure can potentially improve after-tax returns up to 1% p.a. Furthermore, the ETF structure typically better insulates investors from having to pay capital gains tax if there is a high level of redemptions from other investors, when compared to traditional managed funds.

Why low turnover lowers tax

One of the features of index-linked strategies is that they usually don't require a high turnover of stocks from year to year, typically only around 10% a year while an Australian actively managed equity fund can be as high as 80%. The lower the portfolio turnover of a managed investment, the fewer assets will be sold each year and therefore the lower the potential annual capital gains tax (CGT). Low turnover means the tax payable on any accruing capital gains in a portfolio will largely be deferred until the gains are realised at a later date – typically when investors sell their investment – which, in turn, means an investor's portfolio value can remain higher for longer. Investors receive more benefit from return compounding over time.

Low portfolio turnover also means that a greater portion of the assets are likely to have been held for more than a year, giving investors the benefit of CGT discounts applicable on long-term asset holdings. In Australia, individual investors apply a 50% discount to CGT when selling assets held for longer than one year, while superannuation funds (including SMSFs) apply a 33% discount.

We can demonstrate these tax effects using a simple numeric example. Assume that an investor places $100,000 in a managed investment that delivers pre-tax capital growth of 6% per annum, and sells the fund after two years (ignoring management fees and costs and distributions). The table below considers three cases: 1) no turnover in the fund over the whole period 2) a 10% turnover in the portfolio at the end of year one, and 3) an 80% turnover of the portfolio at the end of year one. Increasing portfolio turnover from 10% to 80% - assuming pre-tax returns are the same – significantly reduces post-tax returns. Indeed, for an investor in the top marginal income tax rate of 47%, the post-tax annualised returns are reduced from 4.5% to 3.5%. For superannuation funds (including SMSFs), the post-tax annualised return is reduced by 0.5%.

Taxation impact of Higher Portfolio Turnover

assuming 2-year investment, with 1st year after-tax realised capital gains re-invested

Capital gains tax rate	Pre-tax CAR	Long-term Discount	0% turnover after-tax CAR	10% turnover after-tax CAR	80% turnover after-tax CAR
15%	6.0%	33%	5.7%	5.7%	5.2%
47%	6.0%	50%	4.6%	4.5%	3.5%
39%	6.0%	50%	4.9%	4.7%	3.9%
35%	6.0%	50.0%	5.0%	4.9%	4.1%

CAR = compound annual return

Source:BetaShares

Illustration only. Not indicative of any fund's actual performance. Level of turnover can vary from fund to fund and year to year.

(Calculation details: If there is no turnover in the fund, the fund earns a compound 6% pre-tax return each year, growing to $112,360 on the date of sale. That means the investor is liable to pay tax on capital gains of $12,360. Assuming they are in the top marginal tax rate of 47%, and receive the 50% CGT discount, their tax payable is $2,905, reducing the after-tax value of their investment to $109,455, for an annualised two-year after-tax return of 4.6%. For a superannuation fund receiving a 33% discount on their 15% tax rate, the annualised two-year return is 5.7%. With 80% portfolio turnover at the end of the first year, however, the investor is liable to pay CGT (without any discount) on the 80% value of shares sold at the end of year one, reducing the value of the portfolio heading into year 2 even if all after-tax returns are re-invested. What's more, when the whole investment is then sold at the end of year 2, around 80% of the gains relate to newly purchased assets held for less than one year, and so are again not subject to a CGT discount. Only the 20% of the portfolio held for two years is eligible for the discount. The end result is that the annualised after-tax return for an investor in the top income tax bracket falls to 3.5%. For superannuation funds, the return falls to 5.2%. With portfolio turnover of only 10% at the end of year one, however, the return for an investor in the top income tax bracket is 4.5%, or only 0.2% less than the 'buy and hold' case of zero turnover. For super funds, the return remains close to the 5.7% return for the zero turnover funds (the tax penalty associated with turnover is lower for super funds due to their lower marginal tax rate). The after-tax return is higher than in the case of 80% turnover because less CGT needs to be paid at the end of year one – allowing more of the portfolio to earn extra returns in year two – and because more of the CGT payable at the end of year two is subject to the CGT discount).

Dealing with investor redemptions

Another tax efficiency associated with ETFs is that their unique structure means investors are typically better insulated from having to pay capital gains tax if there is a high level of redemptions from other investors. In the usual managed fund structure, large investor redemptions mean the fund manager has to sell underlying assets to meet the cash demands of departing investors. In most cases – and especially where there are many small investors selling at the same time – it is administratively complex for the fund manager to assign (or 'stream') the capital gains tax associated with these sales to the individual investors in question. Instead, the fund is left with the capital gains tax liability which in turn is passed on to remaining investors in the fund at the end of the financial year.

With an ETF however, even if many small investors seek to sell their ETF holdings on the ASX at the same time, it is the authorised participant (AP) who facilitates these sales (effectively buying ETF units from individual investors in return for cash), and who then undertakes the redemption process with the ETF provider. Due to the fewer but larger redemptions involved, it is easier for the ETF provider to 'stream' the associated capital gains tax payable to the AP, sparing remaining investors in the ETF from having to pay this tax.

David Bassanese is Chief Economist at BetaShares, a leading provider of ETFs. This article is for general information purposes only and neither Cuffelinks nor BetaShares are tax advisers. Readers should obtain professional, independent tax advice before making any investment decision.