Cuffelinks
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What's driving the recent Small Ords surge?

Anton Tagliaferro and Simon Conn

The S&P/ASX Small Ordinaries Index (ASX Small Ords) has surged by over 10% in the last three months on a seemingly new upward trajectory despite what was a fairly mixed reporting season. For the month of October 2017 alone, the Index delivered a gain of 6%.

While the return looks impressive, closer analysis shows that this surge in the Small Ords has been led mainly by concept and momentum stocks, a rather narrow foundation. Leading the charge upwards has been the small cap resource sector, several technology stocks and 'soft commodity' plays with exposure to China. We refer to them as 'concept 'stocks.

Table 1 (next page) highlights the valuations, free cash flow produced as well as these concept stocks' contribution to the Small Ords performance over the last three months.

Some interesting facts:

- While the Small Ords Index was up 10.3% for the three months to 31 October 2017, these 13 stocks accounted for over half of that return.
- This group accounts for $24.4 billion of market capitalisation. This market cap is expected to generate an aggregate of $571 million of reported profit in FY18e - on average a PE of over 40x forecast 2018 earnings and a forecast dividend yield of 1%.
- In addition, these companies are expected to generate an aggregate Free Cash Flow of MINUS $76.6 million or a free cash yield of MINUS 0.3%.

Table 1: Recent key movers on the S&P/ASX Small Ordinaries Index (Small Ords)

Theme	Stock	Mkt cap ($bn)	1 mth perf	3 mth perf	FY18 PE (x)	NPAT ($m)	Earnings yield	FCF ($m)
Technology	Aconex	1.0	+27.3%	+33.3%	146.0	7.0	0.7%	3.8
	Altium	1.6	+10.8%	+36.9%	33.8	45.9	3.0%	50.9
	Afterpay	0.8	+24.4%	+67.7%	52.3	22.1	1.9%	-20.7
	Nextdc	1.5	+18.4%	+25.6%	122	12.1	0.8%	-189.1
	Wistech	3.5	+34.0%	+66.0%	76.4	44.6	1.3%	-5.0
Consumer	A2 Milk	5.2	+30.0%	+84.1%	42.5	149.4	2.4%	122.1
	Bellamy's	1.4	+59.9%	+70.8%	37.8	37.7	2.6%	14.4
	Blackmores	2.7	+35.4%	+80.5%	35.3	78.4	2.8%	94.3
	BWX	0.8	+26.2%	+39.8%	28.4	30.0	3.5%	-11.9
	Costa	2.0	+11.3%	+29.9%	27.9	72.3	3.6%	-13.0
Resources	Galaxy	1.5	+22.7%	+87.5%	37.9	49.4	2.6%	50.0
	Orocobre	1.1	+8.3%	+51.3%	33.2	36.2	3.0%	-6.4
	Pilbara	1.4	+27.6%	+107.7%	nm	-14.3	nm	-166.0
		24.4			49.7	570.8	2.3%	-76.6
PE = Price to Earnings Ratio, NPAT = Net Profit after Tax, FCF = Free Cash Flow								

Based on share prices at 31 October 2017

What does this mean for the rest of the market and for prudent long-term investors?

It appears that in the current market, fundamentals have taken a back seat to momentum, unbounded optimism and the fear of missing out on the next big thing.

On the other hand, quality well-established companies that may have any sort of short-term earnings concerns are being sold down regardless of value. While this is creating great opportunities to buy quality stocks at attractive prices, it is hurting the performance of fundamentally based portfolios such as IML's, particularly given our distinct preference for stocks that meet our quality and value criteria as opposed to concept type stocks.

In the table below are examples of long-established, good quality companies and their fundamentals. The share prices of these companies have actually gone backwards in the last three months.

Stock	Mkt cap ($m)	1 mth perf	3 mth perf	FY18 PE	NPAT(E) ($m)	Earnings yield	Div yield
GWA	675.71	-2.7%	-21.6%	12.8	52.6	7.8%	6.4%
Sky City	2336.85	1.8%	-7.7%	16.0	141.7	6.1%	5.1%
Southern Cross	849.76	-5.1%	-15.5%	10.0	86.9	10.0%	7.2%

Based on share prices at 31 October 2017

We believe investors should focus on the long term and not to get caught up the latest market fad, particularly at times like this when momentum and optimism has taken hold of some sections of the Australian sharemarket. By investing in companies that demonstrate strong competitive advantage, recurring revenues,

with long term growing earnings and that are trading at reasonable prices, more consistent investment returns are expected over the longer term.

Anton Tagliaferro is Investment Director and Simon Conn is Senior Portfolio Manager at Investors Mutual Limited. This information is general in nature and has been prepared without taking into account of the objectives, financial situation or needs of any investor.

How fixed interest is undergoing profound change

Andy Sowerby

For the past 30 years, global fixed income investors have enjoyed an almost unbroken run of positive absolute returns.

Diversified global fixed income has not only done its job of providing protection and diversification but has formed the basis of strong overall portfolio performance, particularly on a risk-adjusted basis. It has been a truly golden period where a relatively static strategy has been highly rewarding. Yet Australians remain significantly under allocated to bonds.

Are bond markets at a turning point?

Recently, more commentators have called an end to this secular bull market. Indeed, in the past few years we have experienced several periods of rising bond yields. In particular, since July 2016 when China unveiled a package of stimulus measures, it signalled a reflationary environment could bring an end to this virtuous bond environment.

Whether this transition is - ideally - slow and gradual, or swift and violent, is still to be seen, but in our view, we are likely to see a change of scenery from the near cyclical lows in yields.

With benchmark duration expanding, creating greater sensitivity to interest rates moves, future traditional fixed income returns appear mediocre at best. At worst, index-constrained investors may end up nursing capital losses as low coupons may not cushion potential price drops.

(Duration measures a bond's price sensitivity to changes in interest rates. For example, if a bond has a duration of five years, its **price** will fall about 5% if its **yield** rises by 1%).

The fallacy of benchmarks

The current construction of the high-profile Bloomberg Barclays Global Aggregate Index highlights the risks that investors may be exposing themselves to, leading to the potential for 'rewardless risk' over the near to medium term.

The rapid rise in the duration of this Index - as shown in the chart below - increases both the sensitivity of the index to future rises in rates and the likelihood of capital erosion.

In addition, the Index currently includes approximately 18,000 issues that span 70 countries and 24 currencies. It is a monster, making it difficult to efficiently replicate, incurring higher transaction costs and greater error in the tracking process. It doesn't necessarily provide the diversification that investors expect. For example, it is heavily biased to countries that have been issuing the most debt; the US, Eurozone and Japan via sovereign bonds, which make up more than half of the Index.

What of return expectations? At 30 June 2017, this Index offered a yield of **1.63%**, offering little protection against the shocks that could lie ahead. About 15% of the underlying securities are paying a negative yield, eating capital in the process. An additional 22% of bonds pay less than 1%. While some investors are tightly mandated to hold allocations close to the Index, those with the ability to make a choice are already on the move.

Figure 1: Bloomberg Barclays Global Aggregate Index Rate and Duration History

Source: Bloomberg Barclays Global Aggregate Index

Flexibility and innovation are critical

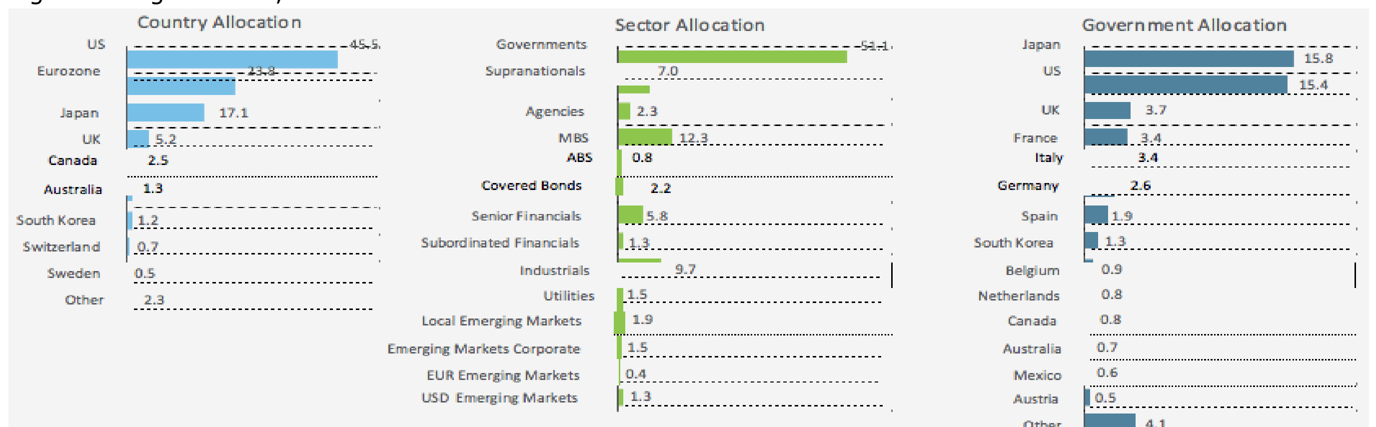
With this backdrop, it is not overly dramatic to say that fixed income investing is going through a sea change. From discussions with investors, there is a far broader agenda on the table with increased scrutiny and deeper thinking around how best to structure exposure in the next market phase. Asset management industry innovation has witnessed the development of niche strategies designed to exploit structural alpha sources through to broadly-based unconstrained approaches that ignore the benchmark in the search for the optimum balance between risk and return.

New approaches and new strategies are the order of the day. However, it is not straightforward as investors fret over how to construct portfolios if core fixed income offers less protection and, potentially, becomes more correlated to traditional growth assets. Indeed, the lines blur further due to the growth of alternative fixed income strategies that are aggressive in their approach, utilising shorting techniques alongside complex trading and derivative strategies.

Finding value in the interconnected bond markets

If the Index is the 'rewardless risk' trade, where is the value in bonds? The chart below shows global bond markets are dominated by a few countries, sectors and investors.

Figure 2: Big universe, limited selection



Source: Bloomberg Barclays Global Aggregate Index

Regardless of the direction of rates, the interconnectedness of global markets and the overpowering presence of central banks fuel dislocations and opportunity, created by:

1. Fear and greed
2. Supply and demand, including non-economic players such as central banks, and
3. Lack of long-term investment horizons.

Due to any combination of these factors, prices can deviate significantly from fundamental fair value, but over time prices typically adjust to reflect inflation, credit fundamentals and liquidity conditions.

Alongside these dislocations sit the economic opportunities that arise as the outlook for growth, inflation and liquidity conditions change. These are impacted by longer term drivers such as indebtedness, demographics and technological change.

Let's look at one of these dislocations, assuming the history of interest rates is the history of inflation, as seen in the Figure 3.

Figure 3: The history of US rates is the history of inflation

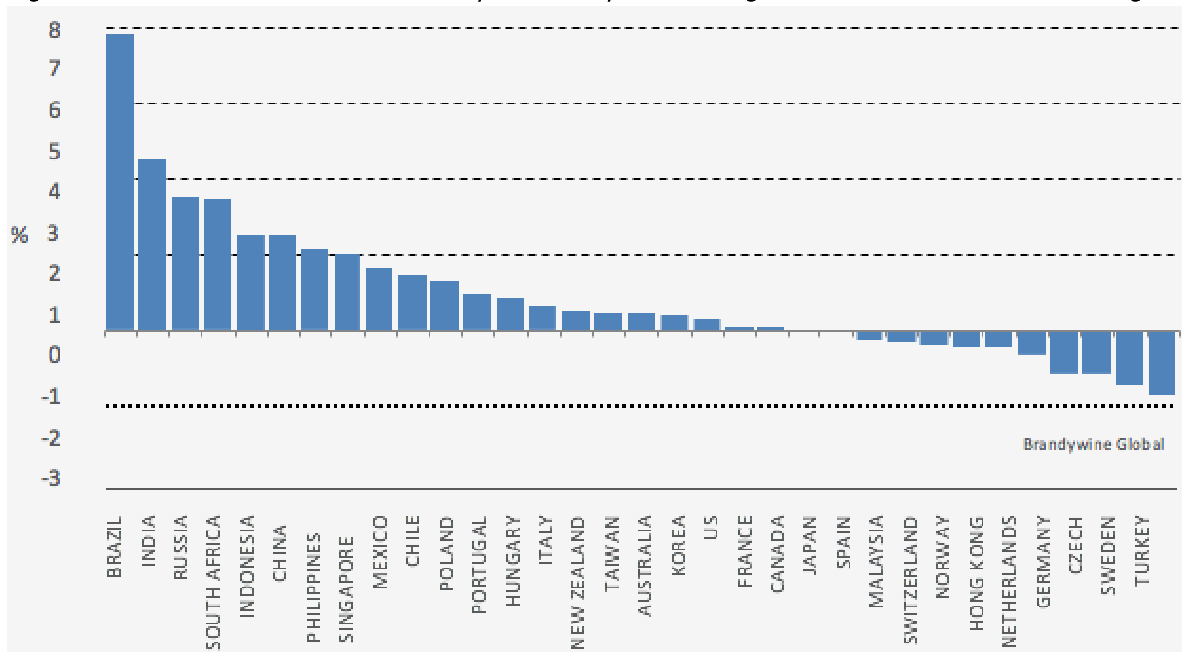
Source: Bloomberg. As of 31 March 2017. PCE = Personal Consumption Expenditures, is an inflation index excluding food and energy.

One could be forgiven for thinking that the fast-growing emerging markets have a higher inflation pace than the traditionally slower developed markets. But this is not the case, as emerging and developed market inflation rates are actually converging.

This is an example of where value can be found.

As the chart below shows, the real yields offered in emerging markets such as Brazil, South Africa, Indonesia and Mexico are attractive at current levels, given the drop in inflation in those countries. This contrasts dramatically with the European developed market stalwarts of the UK and Germany, whose real yields are negative.

Figure 4: Where is the value? Real 10-year bond yield ranking – based on 12-month % change in headline CPI



As of 31 May 2017.

The largest and most important market - US sovereigns - appears to be fairly valued on this analysis and here the debate is most pronounced around the value of the US dollar. A strong argument would be that the greenback is overvalued, measured on a purchasing price parity (PPP) basis, and President Trump would certainly like to see it lower. This trend of a weakening US dollar has been evident since his election in late 2016.

What's next in the 'normalisation' of bonds?

Much is written about normalisation of markets, but - what is normal? Is the post Second World War period any guide at all, or is normal more similar to the nineteenth century when bonds offered low stable yields for multiple decades? How will the great QE experiment end and what tantrums and turmoil might we seeing going forward? And, how does the geo-political flux impact returns and expectations?

As ever in the investing world, asking questions is much easier than finding the answers. The bond market has evolved and developed a range of strategies, instruments and approaches that can be applied to navigate a more complex world. It is this complexity that should drive more investors away from poorly-constructed benchmarks, freeing them to embrace the flexibility and improved return and diversification potential of a more unconstrained or even absolute return approach.

Andy Sowerby is Managing Director at Legg Mason Australia. This article is general information and does not consider the circumstances of any investor.

Has P2P marketplace lending become B2P?

Editor's note: The peer-to-peer (sometimes called P2P or marketplace) lending market has many different operating models, and it continues to evolve as a competitor to banks. There is a question whether it has become more a source of loans for fund managers and large institutional investors rather than a genuine peer market. Here are two views on the local scene, plus an older article from Forbes magazine entitled, 'The Disappearance of Peer-to-Peer Lending'.

Paul Wylie of Mason Stevens comments on P2P lending and John Cummins of SocietyOne responds.

Is peer-to-peer lending self-disrupting?

Paul Wylie

"The power of crowd sourcing always remains with the crowd, not the technological implementation" - Jay Samit

For businesses hyped as the great disruptors of the banking industry, peer-to-peer lenders have lately been doing a better job of disrupting themselves. In peer-to-peer lending (or debt crowdfunding), individuals lend money to other individuals or businesses at a fixed rate of interest. There is usually a formal structure to the debt repayment plan and a fixed return. On the peer-to-peer platform, investors can sometimes sell their debt to other investors prior to maturity and exit the investment.

Is P2P becoming B2P?

The peer-to-peer sector model is to provide a platform where borrowers and lenders can meet. An 'eBay for loans' so to speak that would benefit both borrowers and lenders by cutting out banks. Borrowers receive a lower rate and lenders a higher rate than at a bank. The peer-to-peer lender makes money by taking a cut on any loan.

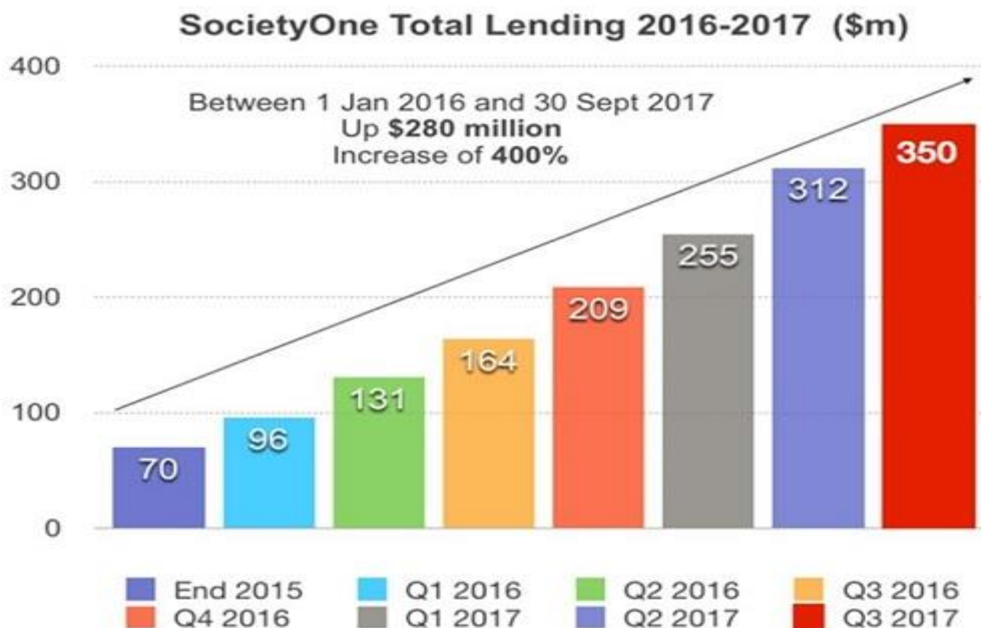
The role of the peer-to-peer lender was to provide the platform or marketplace for loans. It was up to the lenders to decide who they lent to, i.e. who was creditworthy. But as they (and myself as an early seed investor in one of these) found out, most investors don't have the skills to work out what makes one client creditworthy and what makes another one not.

Due to this issue, the original incarnation of peer-to-peer lending has not lasted. As the CEO of Zopa, a UK-based P2P lender said,

"As bad debts soared, the approach was abandoned and Zopa was moulded into a 'big sausage machine'. Its technology now links lenders with a pool of borrowers without any direct contact or the need for investors to make credit decisions."

That function is performed by Zopa. The industry appears to agree that users' interests are best served by a 'black box' approach to arranging loans, rather than allowing individuals to pick and choose who they lend to. Doing so provides simplicity and scale but means, for all their talk of disruption, peer-to-peer lenders are looking more and more like banks.

Australia's major peer-to-peer lender is SocietyOne. It currently has $350 million borrowed through its platform, and is growing rapidly. In fact, loan volumes in the first three quarters of this year have totalled $141 million so far, surpassing the $139 million in loans facilitated over the entire course of 2016, as shown below.



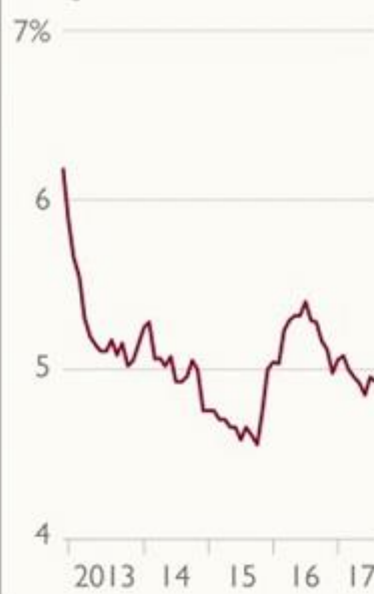
But whilst they have a strong and growing base of borrowers, they are struggling on the lender (investor) side. In October 2017, they announced they had a lender base of 320 individuals, with the remainder of funds being secured from 'partner' banks. In other words, they look a lot more like a consumer finance company as they borrow from banks to lend to individuals.

New model blues

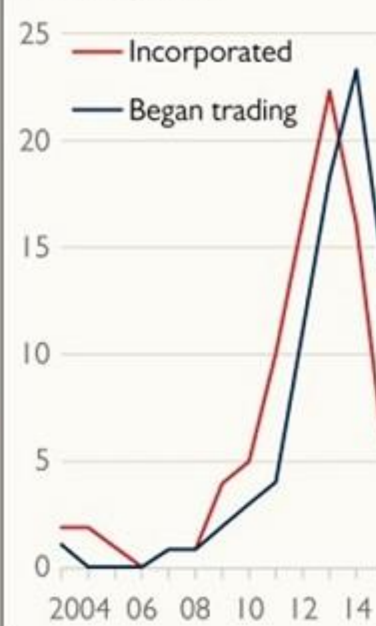
Threats to mainstream banks: peer-to-peer is low down the list

Payment players and facillitators 61%
Payment aggregators 60%
Non-financial service firms 20%
Peer-to-peer lenders 19%
Shadow banks 14%
Robot advisors/ automated wealth-management services 12%
Neo-banks 9%
Other 1%
None of the above 1%

Returns from peer-to-peer lenders have been gradually falling



Growth of number of players has hit a plateau



Source: The Economist Inteligence unit, Altfi Data, Cambridge Centre for Alternative Finance, University of Cambridge

Maybe because they still rely heavily on banks for funding, banks do not see peer-to-peer lenders as a significant disruption risk. Or perhaps it is because the uptake has been so small (US peer-to-peer market is about US$4.5 billion). Either way, they are not the disruptor they originally thought or intended to be.

Paul Wylie is a Fixed Income Investment Strategist at Mason Stevens. This article is general information and does not consider the personal circumstances of any individual.

A response: Talkin' about an evolution

John Cummins

The arrival of the digital peer-to-peer revolution on the global investment scene 10 years ago has been marked by one constant - rapid evolution.

Unlike other forms of fixed income investment, peer-to-peer lending, or as we should call it in Australia, marketplace lending, has had little, if no, time to stand still as the sector has swiftly moved from the margins into the mainstream of investor decision-making.

It's a question of scale

I would certainly agree with Mason Stevens that the original concept of peer-to-peer, basically one-to-one lending or what you might describe as social lending, has changed, particularly when you consider that to be successful in financial services you need to have a degree of scale.

Few, if any, direct one-to-one lenders are going to achieve that rapidly, if at all, and certainly not in a timescale that will help borrowers, lenders, the intermediary and its backers achieve their separate albeit interlinked aims. These goals include obtaining a loan of a size that they want and can afford, returns that satisfy their

investment requirements and revenue that generates cash flow to keep going and profits that produce worthwhile dividends.

To that end, most consumer and business-focused peer-to-peer lenders have accepted (and readily admit) the need to achieve balance in their respective funding mixes, either at the start of operations or someway down the track, to achieve that successful outcome.

In fact, one definition of success is to broaden your offering and appeal to as many investors as possible. This includes an individual looking to put in a small sum, a high-net worth person or SMSF investor searching for better yield or an institution, no matter their size. Most have a mandate to consider new forms of alternative and viable sources of fixed income.

Disruption in different forms

If that means we, as a rapidly-growing sector, are now disrupting ourselves, then we'll plead guilty as charged!

However, I will on behalf of the industry take issue with a couple of Mason Steven's more contentious claims. As our global peers in the US and the UK are showing after a decade or so of pretty decent business, they are doing a good job of disrupting the traditional banking sector.

And let's be clear what disruption really means. Simply, it is to offer a real competitive alternative to those companies which currently dominate the financial and consumer markets to the detriment of the people that they are supposed to serve.

Here, companies like my own, SocietyOne, which launched the Australian version of the digital peer-to-peer revolution in 2012, are considered to be about five years behind in terms of growth and scale.

But based on what SocietyOne has seen since January 2016, where we have experienced a 400% increase in lending to take us past $350 million of total originations since inception, Australians are not only becoming more aware of marketplace lending but are beginning to embrace it.

That's because we are providing that real alternative for both borrowers and investors alike, with lower interest rates on offer to consumers based on their individual credit histories and solid returns in the range of 7-8% to our funders given our technological and cost advantages in being able to connect the two. We also know that the big four banks are beginning to sit up and take note of the challenge we pose.

And talking of challenges, I think it's only fair to contest Mason Steven's claim that SocietyOne is supposedly 'struggling' on the lender side.

We can only have achieved the strong growth in providing more than $280 million of loans to borrowers since January 2016 - and now $150 million of that in 2017 alone - because of the support of our investor funders who match each dollar of demand with a dollar of investment.

We currently have $51 million of committed funding available to support further growth with more funders signing up by the week. The investor-funder mix includes fund managers, insurance companies, banks, wealth managers and of course individual wholesale-qualified investors.

And contrary to the assertion that we have moved away from funding by individuals, we started out five years ago with the deliberate intention of having such a broad mix. We can only run a marketplace efficiently if we have a diversified pool of lenders across the investment spectrum and any good funding manager will always look to diversify their funding risk where possible.

Witness our sourcing $100 million of the $350 million we have advanced in lending so far from 20 mutual banks and credit unions, who incidentally were the original peer-to-peer lenders. They see online businesses like SocietyOne as the digital inheritor of their proud history as pioneers in consumer finance.

So, Mason Stevens, nice try but wrong!

John Cummins is Chief Investment Officer of SocietyOne. This article is general information and does not consider the personal circumstances of any individual.

What is happening in Australian property?

Pat Barrett

A recent Bank of America Merrill Lynch listed property (AREIT) conference in Sydney brought many offshore investors together to meet the AREIT CEOs and management teams. Panels discussed many topics including how to keep shopping malls relevant, the strength of the Sydney commercial market, policy impacts upon the residential sector and capital flows. Meanwhile, Myer released its revised strategy, offering insights into the department store sector. The key points that I took from these updates included:

Retail

- Successful retail assets will be 'urban living rooms', where people go to socialise and get kids out of the house as well as to shop. Landlords are doing whatever it takes to lure people, with some creating architectural features so that the millennials can take their Instagram pictures. Frasers has launched a new Palace Cinema at its Broadway Sydney development (called Central Park) that comprises ten screens, plus three Platinum cinemas and multiple lounge and bar areas. The lounge and bar areas provide food utilising product from existing retailers in the centre in an attempt to make everyone a winner.
- Online retailers don't necessarily have to open physical stores, but it does help cement the brand. The great advantage of online retailers is that they know where their customers are so they can target their strongest markets by opening a physical presence nearby, typically a collection store. There is acknowledgement that the best way to convert a customer is to have a really good physical experience.
- Mirvac commented that some literature regarding the demise of retail underplays the need for human connection. People don't buy some items online, such as clothes, and then stay inside their home. They go out to showcase their goods. People need people. Mirvac has introduced a nanny service in some centres, whereby either the nanny looks after the kids or the nanny comes along to shop. The average spend increased four times with the service.

Residential

- Westpac has been surprised about the lack of defaults thus far in the apartment markets. They've seen good speed to settlement with Melbourne quicker than Sydney. Some developers have been caught in Brisbane and Melbourne in cases where the banks were paid, but the developer struggled to get their equity back. It is expected there will be more issues next year.
- Around half the development sites 10 kilometres from Sydney and Melbourne are owned by Chinese interests who paid full prices. Some have come to the market seeking to get their money back (via an exit). Local players are sitting back and waiting for an excellent deal.
- Non-traditional financiers have entered the market, beating the banks recently to provide debt. One recent deal in Bondi went to a party backed by a US Teachers Pension Fund.
- Sales remain strong with Stockland and Mirvac both reporting good starts to FY18.

Office

- After many decades of lacklustre growth, Melbourne is looking attractive. It offers cheaper rent and much lower capital values versus Sydney, albeit the cap rates are tight. Docklands is now largely developed which means supply shocks should not be as significant as in the past. It's largely local investors buying in Melbourne as offshore buyers still want Sydney.
- Expect some more REITs to sell Sydney assets with pricing cyclically high. A few expected deals include 20 Hunter St, Sydney which was bought in 2013 for about $100 million, now expected to achieve a sale price between $180-$200 million. Then there's 1 Castlereagh St Sydney that was acquired for about $70 million and could reap around $200 million.

Capital flows

- Australian real estate continues to attract massive amounts of global capital. An Australian working in Asia said that everyone loves the Australian market but when he arrives home, locals are talking it down.

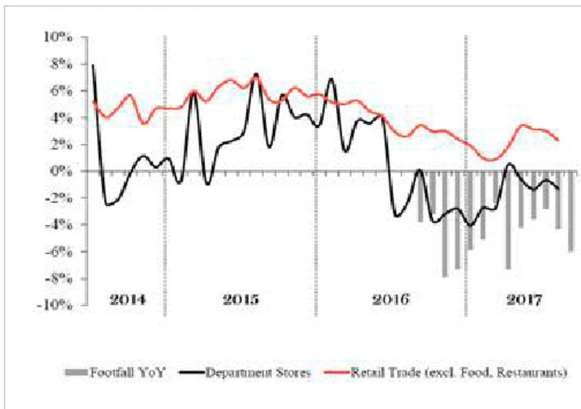
- It's not a homogenous cycle with different rental conditions within sectors. For instance, in the office market, Sydney is in the latter stages of the rental cycle and Perth is at the bottom. In retail there are tough conditions and the industrial is mid cycle.
- In relation to cap rates, there's an argument for this environment to continue ("lower for longer" or as Charter Hall called it, the "Arctic midnight").
- The key issues in past downturns has been oversupply of space, or too much debt. Pleasingly, Australia is well placed on both fronts.
- REITs are happy to develop given comparable pricing for new assets.

Myer and its 128-page strategy update

Myer released its strategy update, recalibrating its prior sales targets due to retail sales growth slowing and declining footfalls in malls. In relation to AREITs, they will have reduced their footprint (m^2) by 10% in FY18, having already closed three stores and handing back space in four stores, with an additional three store closures to occur (Hornsby, Belconnen and Colonnades). Myer acknowledged it was a tough retail environment but still have growth targets (revised down).

There have been some bad news stories out of the US with JC Penney the latest to struggle but Myer tried to quell the pain by highlighting that Australia has less department store space per person than in other developed countries, plus we have population growth. AREITs have been dealing with this issue for over a decade, with most malls reducing their exposure to department stores. However, the long-term contractual leases in place mean that Myer is liable to pay rents for many years to come.

Australian Retail Sales and Footfall Growth YoY (July '14 – June '17)



Source: Myer, ABSRetail Trade, ShopperTrak Retail Traffic Index

Full-line department stores per 1 million people

Source: Myer, US Census, ABS, UK ONS, Statistics Canada

Pat Barrett is a Property Analyst at UBS, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

Mistakes in SMSFs on related party loans

Monica Rule

There are a significant number of professionals giving out some seriously wrong advice on related party lending. Some believe that an SMSF can lend up to 5% of the value of its assets to fund its members or the members' relatives.

Loans to members or their relatives are prohibited by the superannuation law and you can get into trouble with the Tax Office for going down this path.

Why are professionals getting this wrong?

The reason for the mistake is that superannuation law does allow lending of up to 5% to a 'related party' of an SMSF, but there is a qualification people miss. The law is referred to as 'in-house asset' and is covered by section 71 in Part 8 of the superannuation law.

I prefer to write in plain English and I don't normally quote sections of legislations when I write, but bear with me and you will soon understand why I need to do so in this article.

Another area of the superannuation law prohibits a trustee of an SMSF from lending or giving financial assistance to members and relatives. This law appears at section 65 of the superannuation law.

Reading on to subsection 65 (7) of the law states, "**Nothing in Part 8 limits the operation of this section**". Essentially, this means that section 65 overrides section 71 which is in Part 8 of the superannuation law. SMSFs can never lend to their members or members' relatives, not even under the 5% in-house asset limit, regardless of what is allowed under section 71.

Can an SMSF lend to a party who is not a member or a relative of a member of an SMSF?

The good news is it can. An SMSF can lend up to 5% of the total value of its assets to a related entity such as a related company or a related unit trust. It can also lend an unlimited amount to a member's cousin or their former spouse (who are not members of their SMSF) because they are not considered related parties.

The reason an SMSF can lend to a cousin or a former spouse is because the definition of a 'relative' under the general definition in section 10 of the superannuation law does not include a cousin and former spouse. However, just to keep us on our toes, the definition of a relative under section 17A does include a cousin and a former spouse.

The section 17A definition covers the legal structure of an SMSF. It determines which individuals can be in an SMSF together. The section 10 definition, on the other hand, covers investment transactions involving related parties.

So, if your cousin or your former spouse is not a member of your SMSF, then you can lend to them. But if they are members of your SMSF, then your SMSF cannot lend to them.

The superannuation law can be complex as it has various twists. The fact that professionals can get it wrong suggests that if you receive advice that seems too good to be true, get a second opinion. It helps to have a good working knowledge of the law in spotting advice that is not up to the mark.

Monica Rule is an SMSF Specialist and author of The Self Managed Super Handbook – Superannuation Law for SMSFs in plain English. See www.monicarule.com.au.

Moving your SMSF into pension phase

Matthew King

Using your accumulated superannuation benefits to commence a pension is a common way to generate retirement income. If you have an SMSF, there are a few things to consider when starting a pension.

What is an account-based pension?

An account-based pension is like a personal retirement income account operating in a superannuation fund. You receive regular income payments, while at the same time your account may earn investment income. Any investment income earned in the pension account is generally tax-free. Note that before you can start to receive an account-based pension with your super benefits, you must have met a condition of release.

The most common conditions of release are:

- retirement after reaching preservation age
- attaining age 65, or
- permanent incapacity.

Your preservation age depends on when you were born, starting at age 55 years if you were born before 1 July 1960, and increasing by a year each year until it reaches 60 years-of-age for those born after 30 June 1964.

Your SMSF's trust deed must allow the payment of an account-based pension. It is a good time for a general review of your trust deed. An update will generally require the services of a legal professional.

Know your limits

From 1 July 2017, a limit (called the transfer balance cap) applies to the amount of your accumulated superannuation benefits that you can use to commence a pension. The transfer balance cap is a lifetime limit that is set at $1.6 million in 2017/18.

This limit applies to account-based pensions, as well as other types of superannuation income streams you might have such as lifetime or life expectancy pensions, market-linked pensions and defined benefit pensions. However, if you have a transition to retirement pension, it will not be counted until you meet a full condition of release such as retirement after reaching preservation age, attaining age 65 or permanent incapacity.

When you start an account-based pension, the starting balance will count towards your transfer balance cap. If you make a lump sum withdrawal from your pension account, the amount counted towards your transfer balance cap will be reduced. However, pension payments and investment earnings in the pension account will not change the amount of your pension that is measured against your transfer balance cap.

Before starting a pension, speak with your financial adviser to ensure you do not go over your transfer balance cap, as penalties may apply if the cap is exceeded. If you receive another superannuation pension, the combined value of your pensions will generally count towards your transfer balance cap.

Certain transactions that impact your transfer balance cap, such as when you commence a pension or make a lump sum withdrawal, will be reportable to the Australian Taxation Office. Your SMSF administrator or accountant may be able to assist you with these reporting requirements.

Consider your fund's investment strategy

The investment strategy that suited you prior to starting a pension might not continue to be appropriate. One of the objectives of an account-based pension may be that it lasts throughout your lifetime, so it's important to review your investment strategy when setting up your account-based pension.

Your investment strategy should take into consideration that, in moving to an account-based pension you'll be drawing down on your capital. Studies show that the impact of negative returns can be greater when you're drawing down on your capital compared to when you're adding to it.

Make the minimum payments

When running an account-based pension, one of the key requirements is to ensure you draw at least the minimum pension payment amount each financial year. This is an important requirement for maintaining the tax-free status of earnings in your pension account.

The minimum amount you have to draw each year is calculated by multiplying a percentage factor by your account balance. The minimum percentage factor depends on your age when you start the pension and on 1 July for subsequent years.

Age	Payment factor
Under 65	4%
65 - 74	5%
75 - 79	6%
80 - 84	7%
85 - 89	9%
90 - 94	11%
95 and over	14%

If you start your account-based pension part way through the year (prior to June), your minimum pension is calculated in proportion to the number of days remaining in the financial year. If you commence your pension in June, no minimum pension payment is required in that financial year.

When starting a pension, it's important to get a current market valuation of the assets for each member's pension account. The value of your account is required to calculate your minimum payment level, for transfer balance cap purposes and to complete your fund's tax returns. If you don't meet the minimum payment requirements then the assessable investment earnings for the income year may be taxed at 15%, rather than being tax-free. It's not enough for your SMSF to simply 'account' for the minimum payment through a journal entry. Funds must actually be paid from your pension account and leave your SMSF.

Keep your records safe

SMSF trustees are required by law to keep records of transactions of the fund, including those relating to pension payments. These records will also assist your accountant in substantiating your fund's tax position. Generally, records relating to pension payments must be kept for a minimum of five years, but note that some records (e.g. minutes of trustee meetings) must be kept for 10 years.

Estate planning

When you commence a pension, the rules of your SMSF may allow you to nominate a dependant (usually your spouse) to continue to receive the pension after your death, often referred to as a reversionary pension.

Alternatively, you may be able to nominate one or more of your dependants, or your legal personal representative (typically referred to as your estate) to receive your remaining account balance after your death. Death benefits can be paid as a lump sum, a pension or a combination of lump sum and pension. However, only certain dependants (such as your spouse or minor children) are eligible to receive your benefits as a pension. If your superannuation benefits are paid to your estate, the proceeds will be distributed according to the terms of your will.

Your account-based pension can be an important part of your estate planning and it may be appropriate to review your estate planning arrangements when you commence your pension.

Matthew King is a Private Wealth Adviser at Macquarie Bank, a sponsor of Cuffelinks. This information is general in nature and does not take into account your objectives, financial situation or needs.

Are robo-advisers relationship-ready or one-night stands?

Paul Resnik

So, you've met the perfect robo-adviser and it's everything that your human financial adviser isn't. On call 24/7? Check. Available on any device or computer? Check. Totally into you? Check, check and check … or so it seems, from all the promises made on the home page.

But before you go jumping into a relationship with that robo-adviser, think twice and do something more. It may only want the financial advice equivalent of a one-night stand.

Look inside its heart

Robo-advice is simply an automated financial advice process, most commonly leading to a recommended investment. Instead of a person asking questions, you respond on a computer. Then the computer reviews your answers and makes a recommendation, rather than a person making a judgement about your situation.

This can be good or bad. When it's good, it makes advice available to a lot more people who might have missed out on seeing a human. But when it's bad, they can end up receiving advice that might not be suitable for them, and then the relationship does not last.

To find out if a robo is good or bad, find out what makes it tick.

Will it 'ghost' you?

Online dating has introduced the concept of 'ghosting', where someone in a relationship simply vanishes. A partner suddenly cuts communication with the person they have been seeing, and the person realises the partner has lost interest.

Many robos are ghosts-in-waiting.

Investors became excited about robo-advisers 'doing an Uber' on financial advice, so a lot of Silicon Valley types poured money into developing 'entrepreneurial' robo platforms. But many have already vanished and many others soon will because they could not attract enough investment to make any money. Betterment, based in the US, is the world's most successful entrepreneurial robo but it has never made a profit and relies on raising new equity to survive.

Robo offerings from well-known banks, super fund and financial institutions are different. Their job is not to go out and win new money. It is to advise the enterprise's existing customers more quickly, cheaply and consistently than a human (or many humans) could do. They are far more likely to be there for you tomorrow.

Is it really a 'keeper'?

Even among financial institutions not every robo is a 'keeper'. Robos are only as good as the computer programmes that drive them, called 'algorithms'. These sound super-smart, but are not. An algorithm is simply a formulaic way of responding to an input, like:

- It is cloudy, I will take my umbrella
- It is sunny, I will not take my umbrella

However, what if it is cloudy, but we will be parking underground? What if then we decide to briefly walk outside to go to a restaurant? Should we still take an umbrella? What if it's sunny when we get when we are going – where do we put the umbrella then?

Financial planning questions tend to be like that. Things can quickly get terribly complicated. Robos are evolving and some are beginning to contemplate those highly complex issues, like aged care and estate planning. But writing complex algorithms to take account of many different variables is mind-numbingly hard and expensive, so most people don't do it.

Instead, they've given most robos limited abilities and scope. Mostly, they are confined to recommending an investment from a range of 'off-the-shelf' options which is matched to you through your answers to online questions.

Investing is a big, risky deal. To make investment recommendations, the robo must be asking a LOT of questions – right? Unfortunately – wrong. Some barely want to know anything before urging you to invest with them.

It's all about you (or should be)

In the United States, 'Target date funds' only want to know one thing about you – your birthdate. The fund then allocates your assets and automatically converts equities into cash as you age. Personal circumstances, tax considerations and other investments simply don't come into the mix. There is no 'right' number of questions to look for, but one question is probably not going to be enough.

Ideally, before making an investment recommendation, a robo-adviser should ask you questions about three things:

1. Risk tolerance

At the bare minimum it should determine your risk tolerance – that is, the amount of investment risk you will feel comfortable with should markets fluctuate.

2. Risk capacity

Ideally, it would then inquire about your risk capacity – that is, if this investment went badly, could you still achieve your goals?

3. Risk required

A good robo will also talk about 'risk required' – that is, how much risk you need to take on to reach your goal given your starting point.

But there is a trade-off. Some people get bored answering questions, so many robos have quite deliberately kept their questioning brief, although this makes their recommendation less precise.

'Swipe left' on the losers

Robo-advisers must meet the same regulatory and ethical requirements that human advisers are required to meet. Don't put up with automated advice that is self-centred or uninterested in finding out about you. Like a judgement on Tinder, swipe them left out of your life.

Paul Resnik is Co-Founder and Director of Finametrica, a risk profiling system that guides 'best-fit' investment decisions.

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