April 2018 eGrow:

Horror Headlines

Dear Friends,

“Methinks thou doth protest too much…” with apologies to Bill (Shakespeare)

Having spent more than the last decade and a half engaged in media debate about financial services, it always amazes me how the ‘Horror Headlines’ can be so misleading, and how polarised any attempt at a rational debate based on logic has become.

As you know, I firmly believe in getting the best for my clients – but I demand that this is done in a way which is sustainable. **I hate the thought of passing on economic problems to our kids.**

Following the recent announcement by the Opposition of a proposed change to dividend imputation, I am dismayed by how many commentators (who should know better, given their qualifications, training, knowledge and experience) are falling into line, protesting “class warfare” or “a hit on low income earners” depending on which side of the political divide is expedient for them.

They sound to me about as rational as drug-addicts!

I describe the current hysteria to my walking group buddies (and anyone else who will listen) as “the commentariat being blinded by their need for the dopamine hit ***their*** imputation credit refunds provide….”

As many of you will be aware, I love an arbitrage opportunity, but not if this is delivered by poor policy, which is what our political system seems to be dishing up.

Sir Winston Churchill does, however, wisely remind us: “… democracy is the worst form of government …except for all those other forms that have been tried from time to time.”

The ‘horror headlines’ were generated when Bill Shorten announced that if elected, a Labor government will stop the ATO paying tax refunds on shares which have a dividend imputation benefit attached.

There are so many IFs with this announcement...

- **if** they get elected,
- **if** they get it passed in the senate; and
- **if** the public backlash does not change minds or force them to water it down.

Former Liberal opposition leader John Hewson snatched defeat from the jaws of victory when he couldn’t explain how his signature ‘Fight Back’ policy, introducing a GST, would impact on buying a cake. As a result he lost the ‘un lose-able’ election. This may well be Bill Shorten’s ‘Fight Back’ moment – or perhaps, a flash of political genius in burying a potentially unpleasant announcement in the run-up to the Batman and SA Elections.

Imputation policy changes may well not see the light of day – and if they do, they have a strong

chance of being severely watered down (for instance capping imputation credit refunds at $1,000 per person is currently being 'floated'.)

The reason we are having this discussion stems from the former Howard government's tinkering with the imputation credit system which in turn, created a tax anomaly. Basically, it was a political fix to shore up a section of the electorate during a time of economic plenty.

Those days are over, for now.

Now I should declare my hand here. I actually agree with this policy as announced!

Any rational thinking person who has the professional knowledge to fully understand the current tax and long-term savings system will know that the current approach distorts behaviour in investment markets. In terms of the Australian share market, it actually has had a negative effect.

The US share market, in comparison, has no imputation credit system and companies pay very low cash dividends as a result. My investment hero Warren Buffet pays little or NO dividend to his shareholders but retains and reinvests profits in Berkshire Hathaway, which has the effect of boosting the price of the stock.

When asked what action his investors are able to take if there is need for cash from their investment, he advocates selling a small parcel of their shares to realise some capital gains.

Compare that to the 80% dividend payout the banks are currently bragging about in their (investor funded) ads at the moment, to remind us to not pick on them!

Naturally, they pay high dividends to satisfy the imputation credit drug to which many of their investors are addicted.

Here's proof of how the 'drug' distorts reality:

<u>US share market</u>

Dow Jones Low point in early 2009	6,443 points
Dow Jones 16 March 2018	24,946 points

This represents an ALMOST 300% Capital gain over the last 9 years

<u>Australian share market</u>

ASX 200 Low Point in early 2009	3,297 points
ASX 200 16 March 2018	5,947 points

Not even a 100% capital gain ….and we have yet to even reach our pre GCF high of approximately 6,600 points.

"Why is this so?"….. (to quote the late great, Professor Julius Sumner Miller).

It is due largely to the VERY HIGH dividends paid by Australian companies… to provide the imputation credits to which their shareholders are addicted. You could say that this is the equivalent to a 'dopamine high' when they receive their cash from the ATO – it makes them feel great, without considering the long-term impact on their investments and the country.

These investors would have done MUCH, MUCH better to ignore the imputation credit drug that is currently available …and diversified their portfolios 50% to Australian shares and 50% to international shares to reduce risk/volatility, **exactly as we do with YOUR portfolios!**

The background is simple.

Dividend imputation was originally introduced so that shareholders did not pay tax twice - which is logically fair. But returning excess imputation credits as tax refunds distorts the system and costs everyone – (and future budgets) too much.

The following example demonstrates how the imputation credit system was designed to work when introduced in 1987:

Pre-imputation credit regime

Company Profit	$100		
Taxed at 30% Company tax rate -	$30 paid to ATO	Paid to shareholder Taxed in his/her tax return at say 34.5% MTR	$70.00

\- $24.15

Total tax paid by the company and shareholder $30 + $24.15 = $54.15 or 54.15% TOTAL TAX RATE

Post imputation credit regime

Company Profit	$100		
Taxed at 30% Company tax rate -	$30 paid to ATO	Paid to shareholder	$ 70.00
		PLUS Imp Credit offset	$ 30.00
		GROSSED UP AMOUNT	$100.00
		Taxed in his/her tax return 34.5% MTR -	$34.50
		LESS Imputation Credit	$30.00
		NET Tax paid by shareholder	$4.50

Total tax paid by the company and shareholder $30 + $4.50 = $34.50 or 34.5% TOTAL TAX RATE

Imputation credits were NOT refundable at the inception of this system.

The Howard Government then brought in a very generous benefit which allowed those who did not pay tax themselves to not only NOT pay tax on their share income BUT to also receive a cash refund of the tax paid by the company on its profits!

Obviously, that was a significant benefit for a small but growing group … **but at a great cost** in terms of tax revenues for governments and capital gains to the shareholder (as mentioned above) and **eventually to our children!**

Which brings me to the clarification that this is NOT a superannuation or a SMSF change. It is tax proposal to take one of many distortions out of the system.

To demonstrate this point, the headlines scream "200,000 of 600,000 SMSFs will be hit!" In other words, 400,000 of 600,000 SMSFs not addicted to imputation credit refunds are going about their business and doing very well without them.

It is true that if the Opposition's policy is introduced, dividend income will fall – but I believe that balance and logic in the overall tax system will begin to be restored. Companies will, as a result withhold more profits and invest them, employ more people and grow their shareholders wealth.

Remember too that Capital Gains are VERY favourably treated (another of those tax distortions) and remain tax free in account based pensions whether in an SMSF or not!

We need the commentators, the media and the politicians to stop protesting about these proposed changes and to think about them logically.

While the proposal will probably blow up in Bill Shorten's face, he actually has a point. We broke the dividend imputation system and someone needs to fix it – but shouting about it does not achieve anything.

If you are interested in further technical information with respect to this Imputation Credit debate, please also read my attached Media Release No 79 titled 'Addicts Abound in Investment' - as attached for your convenience.

And one more thing:

I usually recommend that people 'tidy up' the number of superannuation funds they have - but as part of that process, I also look at their age and the insurance benefits available under each fund.

Sometimes it is worth keeping as much as $8,000 - $10,000 in a super fund just to retain access to the cheap and broad insurance coverage which may be available within that fund. We have a client (just diagnosed with multiple sclerosis) for whom we had recommended this course of action. As a result, that client will now be able to make a claim from both superfunds (the new fund, and the fund retained).

And by the way, you might be interested in seeing our refreshed website marinisgroup.com.au and/or while you are there, please feel free to have a look at my recent media activity here.

If I or any of my staff can be of assistance, please don't hesitate to call (08) 8130 5130.

Kind Regards,

Theo Marinis B.A., B.Ec., CPA., FPA®
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Authorised Representative

GROW @ Marinis

Media Release No: 79 **4th April 2018**

Addicts abound in investment

By Theo Marinis

- Investment exposed 100% to one stock is fundamentally flawed
- Dopamine overrides logic for the vulnerable
- Wall Street and other indices (and asset classes) are fundamentally different

Over the course of a career, I've marvelled at how many investors are prepared to commit to schemes which can be shut down at the whim of a government minister.

These investors are likely to be the same people who have held time share apartments on the Gold Coast for the last two decades waiting for them to boom like the agent said they would…or have 50 acres of trees just waiting to be harvested when the tax treatment changes, again!

That said, much has recently been written post the Shorten announcement of the ALP's plan to eliminate the refund of excess dividend imputation credits (apparently at the moment, to all BUT age pensioners!).

There are so many 'ifs' around this story that it doesn't really warrant the air-time it has already been given, but what it does point to is one of the flaws the Howard government created in taxation policy, and the vulnerability of investors who have become addicted to the 'dopamine hit' provided by tax driven investments.

Perhaps I'm more than a bit old fashioned, but the old principle applies here: 'If it sounds too good to be true… then it probably is'.

Like any drug of dependence, dopamine (the naturally occurring 'feel good' hit when we do something we think is particularly clever) will ultimately end in a downward spiral.

An example of the impact of this dependency was played out for me some time ago, in the form of an approach by a potential client seeking to maximise Transition to Retirement opportunities (not an uncommon request) as he and his partner moved from accumulation to draw-down phase.

My brief was to provide 'technical/strategic only' advice. The client, a professional his early 60s, had specifically requested not to receive investment advice on an SMSF portfolio valued at $2m, invested 100% in Telstra shares. The investment allocation rationale was based solely on Telstra's high dividend payment track record and accompanying dividend imputation credits.

The scope of the terms of my engagement expressly excluded the provision of investment advice; this did not mean, however, that my professional obligations to flag the risks associated with not addressing related advice areas (in this case, an appropriate investment strategy) could be similarly 'scoped' out.

The risks – primarily the serious lack of diversity in the portfolio and the fact that it was not in line with the clients' identified investment risk profile – formed the subject of some lengthy discussions, as well as part of my formal written advice.

But the estimated income yield delivered by the transition to retirement strategy (including the ***full*** refund of Telstra's imputation credits) was the hook. Warnings highlighting the serious risks involved in not diversifying the portfolio were happily dismissed.

A few years later, due to some circumstantial changes, I was again approached by the same individual to provide additional technical strategy advice. By this time the portfolio had been 'diversified'; the Telstra holdings had been diluted to just a quarter of the portfolio – fortunately before the corporation had lost 40% in capitalisation. The proceeds from the sell down had been applied to buy shareholdings in the big four Australian banks, plus one of the smaller ones… with investment allocation continuing to be driven by the 'siren song' of dividend policies and imputation credits.

The portfolio now held six stocks, representing 94% of the SMSF investment exposure, held entirely in the local market.

Concerns regarding the risks associated with exposure to a handful of stocks in a single market, the portfolio's vulnerability to the ebb and flow of global capital (notwithstanding the fact that a retirement income strategy based on 94% growth and 6% defensive asset exposure was not a rational or recommended approach) were raised.

An offer of investment strategy advice was again deemed unnecessary, on the basis of what I could only conclude to be the same dividend driven 'dopamine hit' overriding logic.

In the expectation that this case will be dismissed by some as a 'one off, extreme example' broader evidence of the impact of chasing imputation credit refunds can be found in the aftermath of the GFC.

To use an expression by Warren Buffett, many pension funds (both SMSF and non SMSF) "were caught naked when the tide went out". For a number of years, due to severely impaired dividend payments, the prescribed ABP pensions could not be paid from income without selling shares at a significant loss.

The reason? An overexposure in 'pension phase' super funds to Australian shares, and an addiction to their associated imputation credits (not to mention a home equity bias – another cognitive distortion) following the sudden and synchronised 50%+ fall in world share markets in 2008/09. The resulting post GFC fall in profits also saw large falls in dividends.

As a result, for a number of financial years, that famous duo, Howard and Costello were forced to halve the prescribed minimum percentage payments for account based pensions. It could be said

that this rule change was necessitated in the wake of the distortion caused by their previous imputation credit policies – a distortion which continues!

Diversify and avoid having to go cold turkey

Post GFC, NONE our clients were forced to live off 50% the normal ABP minimum amounts, which meant that their retirement incomes were not compromised. There were two reasons why this was the case:

Their investment portfolios were all fully diversified, with adequate cash and fixed interest buffers to ride out the storm; they also had 50% of their share exposure overseas, as a volatility reduction strategy.

During the GFC, when ALL share markets fell around 50% or more, the $A fell more than 50%. This meant losses on overseas share market investments were more than made up for on the exchange rate movement on their overseas investments. This strategy worked exactly as it was designed to do.

Sticking to investing ONLY in shares at home – without having some global exposure – for example, the US market – is a major flaw in any investment portfolio.

There are some massive structural differences and investment exposure in the two indices which provide the astute investor the opportunity for significant capital gains in the US, and robust dividends in Australia. Similarly, Asia offers enormous potential.

Instead of treating your investments like a punt at the track, always follow the first three rules of Investment: diversify, diversify and diversify!

That means diversifying within all asset classes and across all asset classes and doing it with low cost index funds. In the long term, you will always get a better and less volatile outcome and a happier retirement!

If you think you might be a dopamine addict, act quickly. Go and see your broker or financial adviser and take the 12-step plan… to diversification.

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