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Contents

Editorial

James Gruber is still on the mend so I'm afraid you're stuck with me again. Before we get to today's articles, I thought I'd talk about a couple of tricks I see used to sell financial products.

There's a saying in marketing and sales that nobody likes being sold, but everybody loves to buy.

Take giving to charity for example. I think most people feel pretty good while writing a cheque to a cause that means a lot to them, or to something a friend is raising money for. I know I do. At the same time, I doubt I am alone in bracing for impact whenever a charity canvasser steps merrily towards me.

People hate being sold to. So, how do marketers and salespeople get around this?

First of all, they will try to focus more on the destination or desired state of being than the product itself.

People love buying because it feels like taking a step towards the future self they want to be. They don't sell you the car, they sell you the family days at the beach. They think about where you are and where you want to go. Then they sell you the road there.

They will also use mind tricks.

These little tactics are based on behavioural science. Their aim is to bump you towards the action the persuader wants you to take. In many cases, you will end up using these tricks on yourself. After all, the most convincing salesperson is the one in our own head.

Robert Cialdini outlined 7 key methods of persuasion in his classic book Influence. Today I'm going to focus on two that I see often in finance – scarcity and authority.

Scarcity is when the promoter tries to stoke a fear of missing out. A promoter will do this by ascribing some kind of limit to the opportunity being offered. Either in regards to how many of it are left (only 13 spaces left at this price!) or by putting a deadline on it (sale ends at midnight!). By doing this, they are hoping to inspire that FOMO and encourage action.

My investment platform in the UK has been telling me to lock in high yields before interest rates fall for about a year now. They are using scarcity. Or you might see a fund manager touting a "once in a generation" opportunity for *X* style of stocks – usually the type they invest in. By saying it is once in a generation, they are implying the opportunity will close and you could miss out.

The most obvious form of authority is some kind of track record. These vary greatly in the quality of information being conveyed. But because humans are subconsciously drawn to authority, lower value indicators of this nature can still be very compelling.

I would say that a 20-year performance record across various economic cycles is genuinely valuable information. Meanwhile, promotions based on shorter track records, hypothetical returns based on back-testing, or some guru's predictions in the past are far lower quality signals.

You might see an idea being touted using a headline like "stock manager who picked Nvidia at $8 announces new tech position" or "analyst who predicted the Great Recession sees new crash coming".

The past prediction, which could have been one of thousands of other calls made by the same person, is being used to boost the credibility of the next prediction. Even though the next event being predicted is completely independent from the previous one. It isn't that far away from the gambler's fallacy – and for good reason. People selling hot tips know their audience.

Another form of "authority" you'll see is the assertion that big institutions or the ultra-wealthy are investing in a certain way, so everyday investors should too. I am seeing a lot of this now when it comes to private and alternatives assets. Just remember that while the facts being presented might be true, they are probably carefully chosen weapons of persuasion.

These facts are often presented without crucial context. Like what other assets the wealthy person holds alongside the asset in question or what they are really trying to accomplish by holding it. In the case of alternative assets like art, maybe they just like the painting. We don't have to turn everything into an asset class.

In my article this week, I ask whether outdated accounting methods have made ratios like price-to-earnings less valuable than they once were. If you've been wondering why low P/E, low price to book methods haven't been so hot recently, this could explain why.

Also in today's edition…

Investors have crammed into increasingly narrow areas of the stock market with increasingly high valuations. **Martin Conlon** from **Schroders** thinks investors are threading the eye of a needle. In this article, Conlon reveals why he doesn't share the market's enthusiasm for CBA. He also discusses the Guzman y Gomez IPO, pathology stocks and other cases where investors appear to be overhyping or overlooking the stocks in question.

While few debate the fact that Earth is experiencing climate change, the economic impact of these changes is far less certain. **Joachim Klement** highlights new research modeling how different regions and their economies will be affected. The results diverge greatly between countries and could have a profound impact on everything from migration flows to ESG investing themes.

Claiming personal super contributions as a tax deduction can be a handy way to reduce your tax bill. However, misunderstanding the eligibility rules can prevent you from receiving the deduction you were hoping for. You could even miss out altogether. **Julie Steed** outlines the criteria you must meet to successfully claim a tax deduction and discusses common pitfalls like partial withdrawals.

Healthcare and education are just two areas that stand to benefit from advances in artificial intelligence. **Dr Kevin Hebner** from **Epoch Investment Partners** warns governments against regulating away the gains that AI can bring to society. While this investment theme looks set to dominate for at least a decade, there is only room for a small number of winners in each segment of the industry.

The excitement of retiring can be stunted by the fear of running out of money and the difficulty of shifting your mentality from saving to withdrawing. Both situations result in uncertainty and, in many cases, a less comfortable retirement than you can actually afford. **Justine Marquet** from **Allianz Retire+** highlights the value of certainty in retirement and how you can go about increasing yours.

Our featured white paper is **Magellan**'s recent letter to Global Equities clients. The letter discusses several big themes set to impact markets going forward. These include the state of the global consumer, China's place in the world and why you should always be wary of naysayers.

Joseph Taylor

Have value investors been hindered by this quirk of accounting?

Joseph Taylor

A couple of weeks ago I wrote an article on why so few fund managers have managed to replicate Buffett's success in the professional arena. The article was inspired by listening to a recent podcast appearance by Robert Hagstrom, author of The Warren Buffett Way.

Hagstrom's return to the podcast circuit wasn't a coincidence. The fourth edition of his book recently landed. The big draw of the new edition – launched to celebrate the book's 30th anniversary – is a new Buffett case study to follow earlier ones on Geico, Coke, Amex, Heinz and IBM.

The new case study is Buffett's purchase of Apple in 2017. I won't give too much away, but Hagstrom spends a fair bit of time talking about Michael Mauboussin's assertion that accounting conventions have failed to keep up with economic reality.

Is the denominator broken?

For decades – maybe even a century or more – investors have relied on ratios like price-to-earnings and price-to-book as a barometer of relative value.

If a stock's P/E is far higher than that of the general market, it is common to see the shares being written off as overvalued. If a stock trades at a far lower P/E ratio than the market average, investors seeking a bargain might jump in.

I'd argue that there is a lot more to value investing than buying stocks with cheap P/E ratios. But it is undoubtedly the general understanding of the strategy – even if simplistic. The ratio is so ingrained that many investors experience knee-jerk reactions once a P/E passes a certain point in either direction. A P/E of under 12 and the so-called value investor leans in on instinct. Anything above 25 and they instantly write off the shares.

One problem with P/E is that it is often based on last year's earnings, while investing is all about what is going to happen in the future. For that reason, a stock with a high backwards looking P/E can actually be very cheap. Another problem, and the topic of today's article, is that the denominator – reported net income – is heavily influenced by accounting rules.

According to Mauboussin, those rules no longer match up with how value is created in many industries. His paper *Intangible assets and earnings* (written for Morgan Stanley) argues that accounting conventions were built to fit industrial businesses dominated by tangible assets. They are not made to accommodate companies that invest more in *intangible assets* like R&D and customer acquisition.

These companies, Mauboussin suggests, end up reporting lower profits than they could have done otherwise. Why? Because their intangible investments, which are as essential to them as trucks and drills are to a miner, are expensed from profits straight away. This is very different to the treatment of tangible investments, which are recorded as an asset on the balance sheet and depreciated over several years.

Accounting rules are simply a universally agreed and applied mechanism to report financial results. As investors we are buying businesses and there is science involved in the process of evaluating businesses – but there is also a good deal of art as well.

Adjusting reported earnings for modern reality

In his paper, Mauboussin references a study by Iqbal and co, a group of accountants trying to estimate what percentage of common income statement expenses could be considered as 'intangible investments' – and therefore moved to the balance sheet.

The paper focused on SG&A (sales, general and administrative costs) and R&D (research and development). In their pre-amble, they note a rule of thumb that 30% of SGA and 100% of R&D could be considered as investments rather than expenses. I hadn't heard this before and, like the paper's authors, thought it sounded far too arbitrary. Iqbal and co's goal was to reflect the different nature of various industries through different adjustments to R&D and SGA.

I am not completely sure how they arrived at the numbers they did. There is a mathematical explanation in the paper that is beyond my level of left-brain intelligence. The results, though, are pretty clear. For some industries, they think *a lot* of costs currently taken to the income statement could be capitalised on the balance sheet instead. Here is a sample of the numbers they arrived at:

Industry	% of SGA with capitalisation potential (years of useful life)	% of R&D with capitalisation potential (years of useful life)
Pharmaceuticals	85% (3.3 years)	91% (4.8 years)
Medical Equipment	90% (3.6 years)	93% (4.5 years)
Consumer Goods	72% (4.4 years)	88% (1.9 years)
Coal	62% (3.6 years)	3% (4.2 years)

For companies that spend a decent percentage of sales on SGA and R&D, making these adjustments to the reported earnings would leave them with far higher reported earnings. In turn, this would have a big impact on how expensive their P/E multiples would look on an adjusted basis. It would also increase the book value of these companies and make their price-to-book look cheaper.

I would, however, raise a couple of potential issues. Number one is that gauging the correct level of adjustment seems extremely hard. You would need intricate knowledge not only of the industry but also the specific business. The weighted average adjustment (69% for SGA and 87% for R&D) covering all of the industries in the study is high. Could this be used as an excuse to pay more for *any* stock?

The effects of these adjustments are also biggest in the first year you make them. This is because the new 'intangible investments' account we create on the balance sheet gets bigger each year and leads to higher charges from that account in future years. Unless a company's revenue and profits grow rapidly ahead of the amounts previously invested, the positive impact of the re-shuffling decreases.

As an example, I applied these adjustments to the results of a well-known ASX share. Fiddling with the 2023 results alone added over $750m to what they reported as pre-tax profit. Assuming the same effective tax rate, the P/E of the stock falls from over 30 to 18 on an adjusted basis.

But look what happens when I start these tweaks in 2021 and roll them forward. The depreciation charge rises and the uplift in pre-tax profit by the time I reach 2023 falls by almost $300m. As a result, the "new" P/E ratio is 21.5 instead of 18. The company still looks cheaper than the standard P/E ratio, it's just something to keep in mind if someone tries to dazzle you with adjusted numbers.

Of course for a company's adjusted P/E to be useful on a comparative basis, you'd need to adjust the earnings of several other companies too. Oh, and don't forget that my example took 90%+ adjustments to R&D and SGA as gospel. I don't take them as gospel and was just trying to illustrate a point.

Do we need an accounting overhaul?

If Mauboussin, Iqbal and co are right about intangible investments, do we need an overhaul of accounting rules to suit modern business? Or will investors simply need to be more thoughtful about the ratios and shortcuts they choose?

Maybe this quirk of accounting goes some way to explaining why systematic low P/E, low price to book strategies haven't worked as well as they did in the past. A whole swathe of companies may have been excluded for being too expensive when they weren't. A lot of companies only look cheap in hindsight and never at the time.

I assume that quantitative value funds have tweaked their algorithms to account for this. Potentially by using cash flow metrics rather than earnings. Maybe even by adjusting what they include in book value. Investors still relying on P/E as a quick gauge of value, however, may need to look a little closer.

Joseph Taylor is an Associate Investment Specialist, Morningstar Australia and Firstlinks.

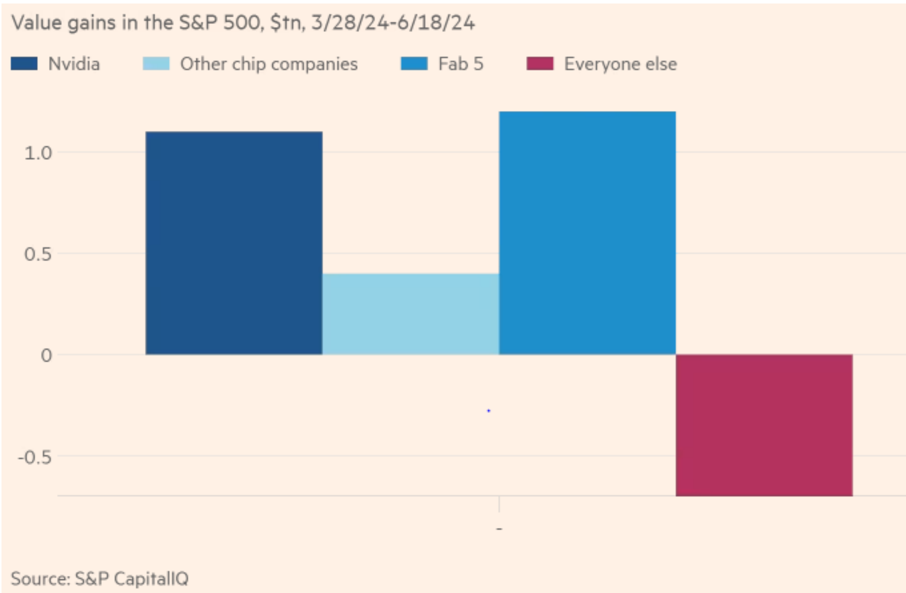
Investors are threading the eye of the needle

Martin Conlon

For those believing the price you pay for an investment is an important determinant of future returns, life isn't comfortable.

Momentum and stories rule as ever more capital seeks to squeeze through the eye of the needle. As Robert Armstrong detailed in a recent Financial Times article, recent months have seen an alarming narrowing in equity market returns.

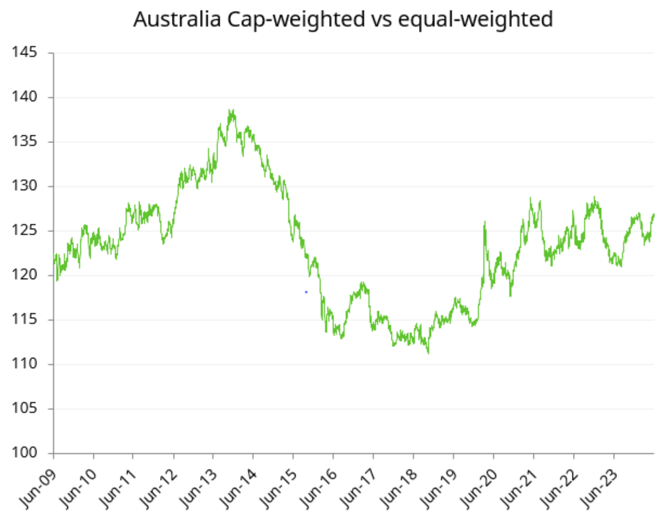
"All of the gains in the market - and more – are from companies touched by AI. The S&P 500 as a whole is up more than 4 per cent. The non-AI 484 is down 2 per cent." The top 10% of companies in the US now represent the highest proportion of market value in the index since the 1930s."

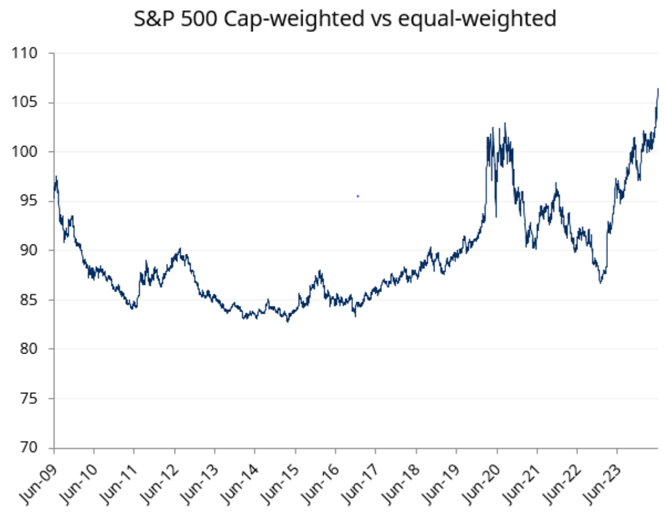


Source: FT

Narrowing stock markets are normally a bad sign. For those believing these valuations will be justified by future profits, they must necessarily be associated with narrower economies and/or increasing profit margins from already very high levels (which means a lower share for wages).

The narrowing of markets in the US has largely been due to AI and tech mania taking hold in the past year. In Australia, the process has been more gradual since the savaging of large resource companies in the 2014-2016 period.





Source: Schroders, Datastream

Determining the reasons for this collapsing breadth is tricky. The ongoing supremacy of passive and systematic investment is almost certainly a factor. Yet the narrowing of underlying economies also seems to play a reasonable part.

As productivity gains evaporate and the services economy becomes ever more important, money illusion, confidence and asset prices have elevated as levers to hold modern economies together.

Technology may provide some exciting prospects, but construction, retail and services are the employment engines of the economy. And recent feedback from retailers, developers and anyone exposed to consumers is consistent - activity is slowing sharply.

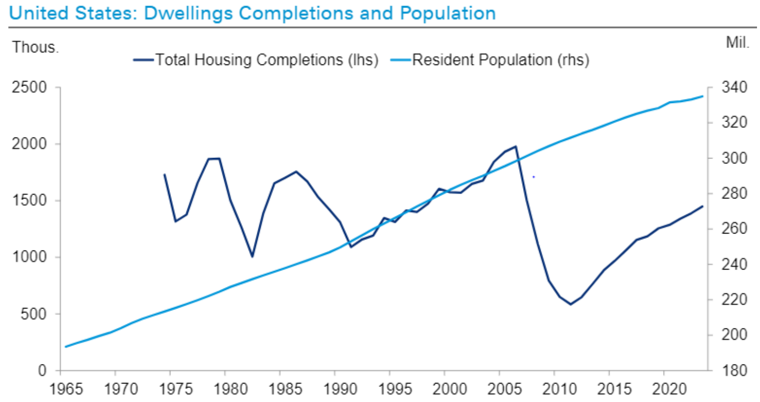
Some of the most worrying trends, particularly domestically, are in housing. The costs of a speculation scheme fuelled by long-run debt and immigration are becoming more evident. Across almost all of the western world, the number of houses completed relative to population is falling towards historic lows.

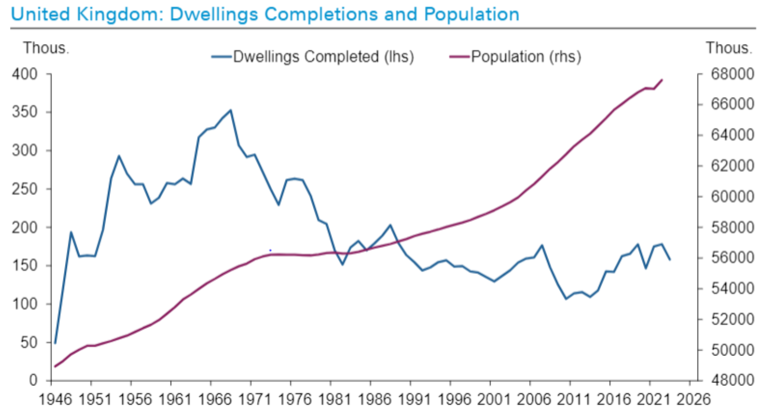
Land prices, regulatory costs, labour availability and generally rising construction costs are combining with more normal levels of interest rates to challenge housing affordability everywhere. When no-one can afford houses, developers stop building them. Despite government assertions, a solution that doesn't involve falling property prices looks increasingly implausible.

The strong performance of banks over recent months sits at odds with this reality. While the resource market, a barometer of real economic activity globally, has deteriorated, the barometer of the financial economy is off to the races.

CBA, one of the most expensive banks globally, continues to confound us and many other market observers. Disproportionately owned by passive and retail shareholders, CBA is making a significant contribution to Australia's deteriorating market breadth as its valuation (rather than profits) edges ever higher.

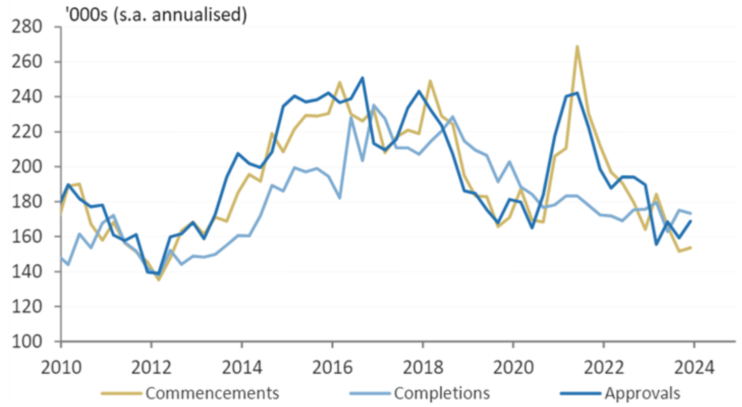
Investors continue to wager on the value of the financial economy being able to separate from the profits of the economy which it is designed to facilitate. We feel differently.





Source: Deutsche Bank, Haver Analytics, ONB, US Census Bureau

Australian Building Approvals, Commencements and Completions



Source: Morgan Stanley

Numbers versus narrative

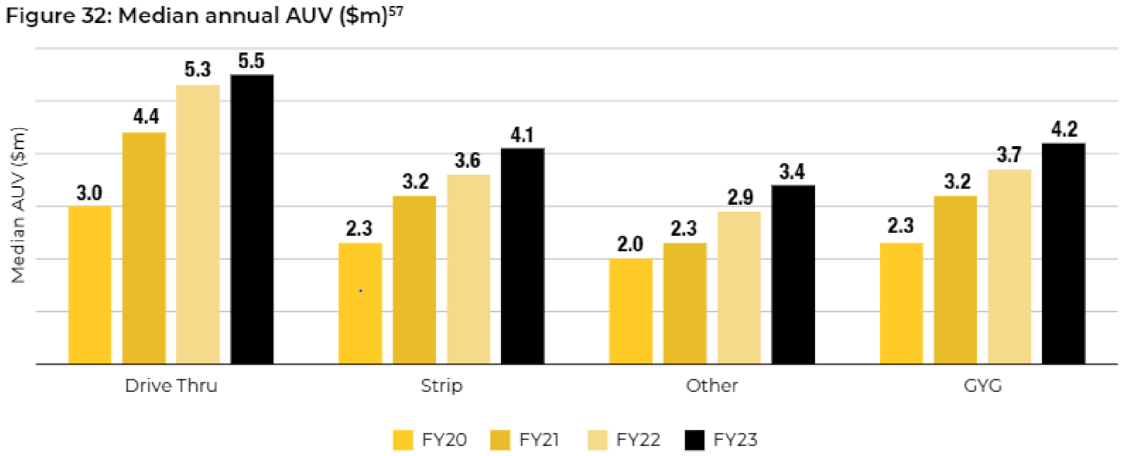
For those of us waiting for some rationality to return to equity market valuation, the Guzman Y Gomez (GYG) IPO was not a day for high fives all round.

Capturing the imagination of investors remains a far more appealing way of creating market value than the hard yards of making money. While applauding the job GYG management have done getting the business to its current position, our role as investors is to determine a reasonable business valuation.

In an era in which high margins, growth, and avoiding capital commitment are the holy grail, franchisor and franchisee structures have unsurprisingly boomed in popularity. These arrangements can centralise functions and split the earnings of a retail operation between different parties, however, the sales and profit per store will always dictate the envelope of total profit and value available to split.

GYG currently has a little under 200 stores and a little over $750 million in network sales. Stores are currently exceptionally profitable versus most comparable businesses, making margins of nearly 20% on average sales of $4-$5 million (per the chart below).

GYG Sales Per Store



This exceptional profitability allows the franchisor to take around $0.5 million per store while leaving a similar amount for the franchisee (on an investment of <$2 million). Assuming one is prepared to assume this high level of profitability is sustainable (a very brave assumption), 10x EBIT for a mature store might allow a value per store of around $10 million, split fairly evenly between franchisor and franchisee, with the latter funding the $2 million store cost.

On this basis, the 62 corporate restaurants and 123 franchise stores would be expected to deliver around $120 million EBIT ($1 million for each corporate store and $0.5 million for each franchised store) and would justify around $1.2 billion of value on a mature store basis (ignoring all other costs).

In reality, around $1 billion of this value is absorbed in running costs, with GYG pro forma EBIT of around $12 million for 2024 and <$20 million for 2025. This rudimentary maths leaves the business delivering earnings which only justify $200-$300 million of value currently, meaning the remaining $2.7-$2.8 billion of the current $3 billion equity valuation is the 'blue sky' of store rollout.

While anything is possible, shareholders appear to be planning on a lot of people eating a lot more burritos. Investing is about assessing the odds. From our perspective the odds here look exceedingly poor.

The Metcash annual result offered the opportunity to compare a retail valuation at the other end of the spectrum. For a total equity valuation of less than $4 billion (within spitting distance of GYG), Metcash reported operating profit and cashflow of a little under $500 million (around 25 times that of GYG for 1.3x times the price).

Providing wholesale supply services (together with some store ownership) to nearly 1,300 supermarkets, 3,300 liquor stores and 600+ hardware stores, high levels of growth in stores may be behind Metcash. The good news for shareholders is the profits have already arrived.

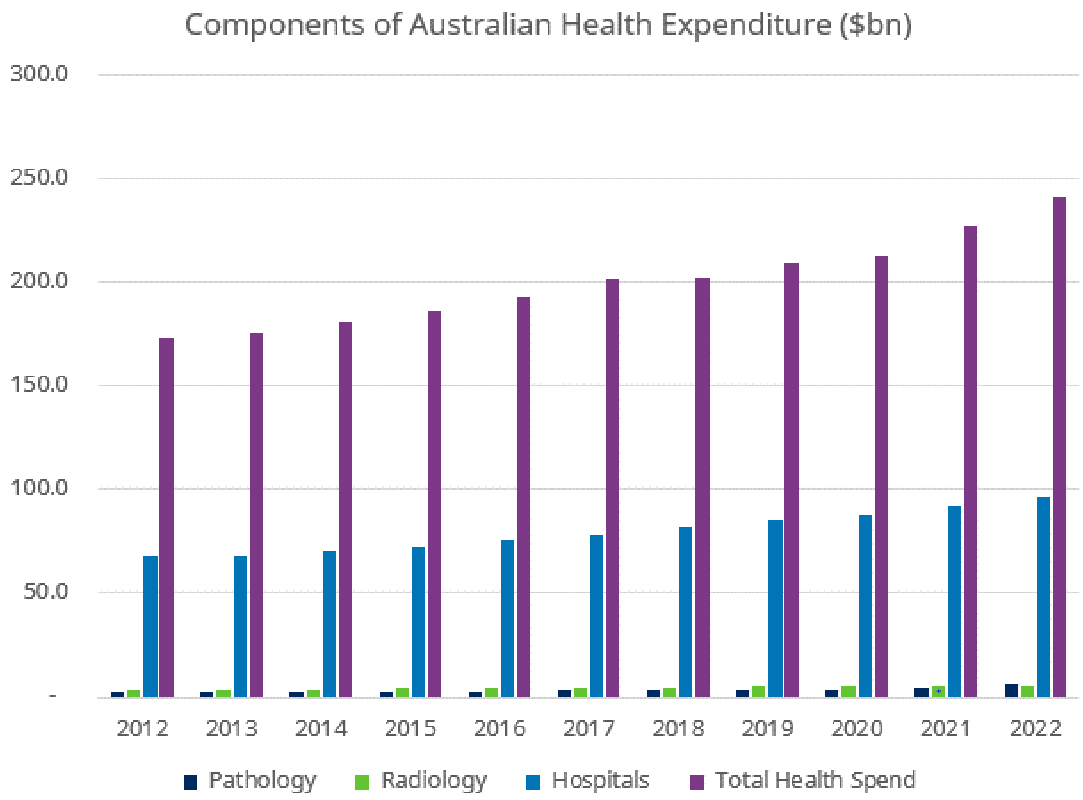
Interestingly, Metcash is also the 100% owner of the Totals Tools franchise (and through joint ventures, the majority owner of more than 50 stores). A store network of 118 stores produces network sales of around $1.1 billion ($10 million per store and store margins well above 10%), giving rise to a similar value per store to GYG if one accepts these metrics are sustainable.

The $82 million of EBIT (only $34 million of costs is unallocated across the total business) is already well ahead of levels delivered by GYG. As Metcash shareholders we may be biased, but we find the extent to which valuations of apparently similar earnings streams are accorded wildly divergent valuations mind boggling.

In perhaps another similar example, we have watched shares in Pro Medicus rise inexorably (up another 38.1% over the past quarter), to reach a market value of almost $15 billion. This $15 billion buys forecast revenues for 2024 of around $160 million and operating profit of a little over $100 million at extraordinary margins. Perhaps we're old fashioned, but nearly 100 times revenue and 150 times operating profit seems like a lot.

Sonic Healthcare, one of the larger pathology and radiology operators globally, has forecast revenue of around $8.9 billion and operating profit of a little over $800 million. These metrics buy an equity valuation some $2 billion less than Pro Medicus.

We are extremely positive on the future for pathology and radiology. As the dominant tools in preventative healthcare (diagnosing and treating problems early, rather than waiting until vastly higher cost medical intervention is required), we struggle to understand why the split of health spending looks anything like the chart below.



Source: Schroders, ABS

Loosening the purse strings and encouraging more preventative testing in order to reduce spending on extremely costly intervention seems like a no-brainer for both productivity and quality of life for the population. In addition, we see it as one of the more promising applications for AI.

Sonic Healthcare has one of the most extensive data sets of pathology and radiology results together with stakes or full ownership in technology businesses such as Harrison AI (across both pathology (Franklin AI) and radiology (Annalise AI)), Pathology Watch in dermatological pathology and in technology for GP's.

In addition, you get actual pathology and radiology operations which may be pesky for technology loving shareholders yet are somewhat useful in providing the services which help diagnose and cure people.

As a core part of operations, most companies need to carefully consider how much of their technology operations they are prepared to outsource. The business development path of using attractively priced subscription-based technology to establish a market position and then leverage that position into ongoing price increases, which strip any productivity gains from the customer, is now well-trodden.

Companies that are effectively internalising important elements of technology seem far more appealing to us than pure technology companies expected to gorge on the blood of unsuspecting hosts long into the future.

Martin Conlon is Head of Australian Equities at [Schroders](), a sponsor of Firstlinks. This article does not contain and should not be taken as containing any financial product advice or financial product recommendations. It does not take into consideration your personal objectives, financial situation or needs.

This article is an excerpt from Martin's July 2024 market commentary 'Threading the eye of the needle'. You can read the full version here.

For more articles and papers from Schroders, click here.

Persistent, but not permanent

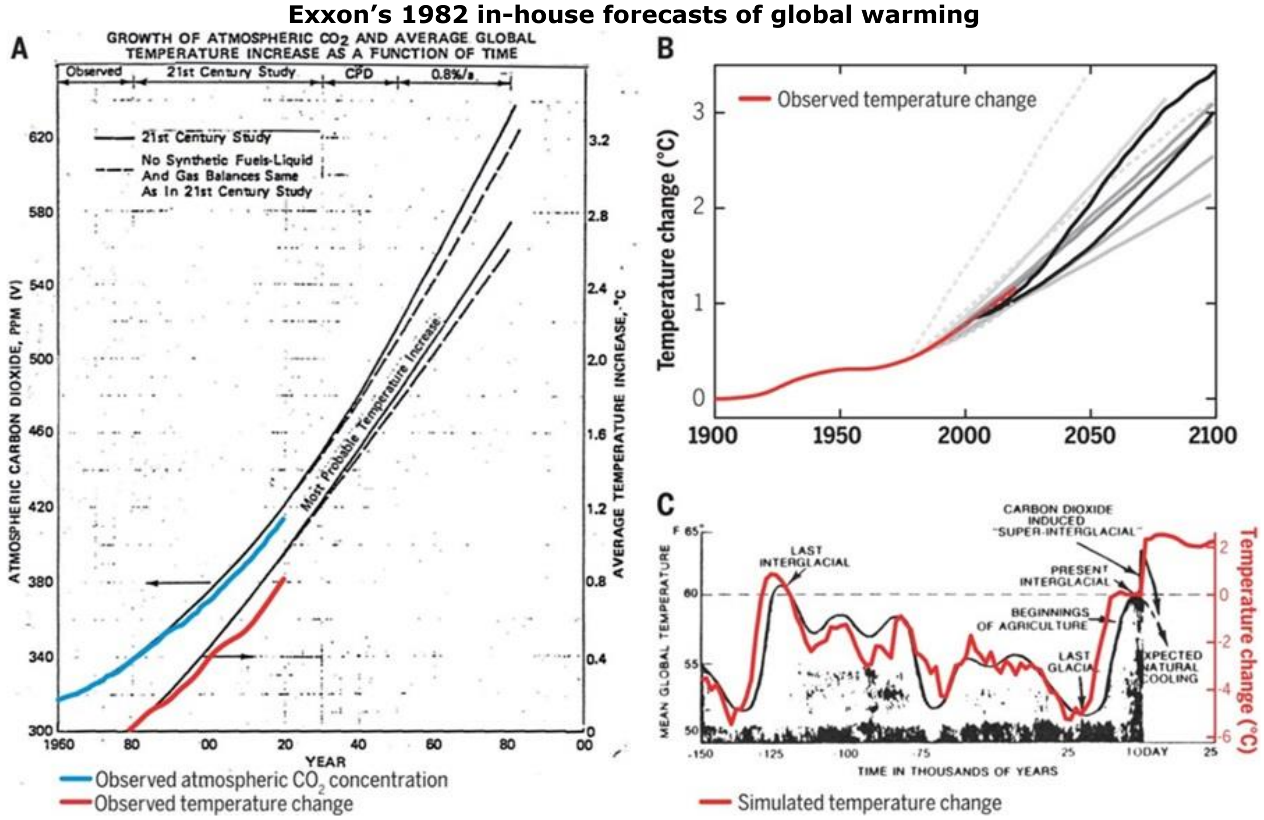
Joachim Klement

While there is universal consensus that we experience climate change there is much more uncertainty about how much this will impact economic growth and output. While we have very good climate change models that are remarkably precise, our economic models for the impact of climate change are more dispersed. Which is why it is worthwhile checking in on some new research.

How accurate climate change models were already in the early 1980s came to light when investigative journalists uncovered internal documents from Exxon from 1982 that modelled the impact of greenhouse gas emissions on temperature.

These models were some of the earliest climate change models around, yet they managed to forecast actual temperature changes quite well. And Exxon decided to cover up this in-house research and instead fund a decades-long campaign to convince the public that burning fossil fuels would not lead to climate change. In case you don't know about this story, I suggest you read this scientific analysis of Exxon's actions or just look at Exxon's projections from 1982 with the actual change in greenhouse gas emissions and global temperature in the chart below.

Exxon's 1982 in-house forecasts of global warming



Source: Supran et al. (2023).

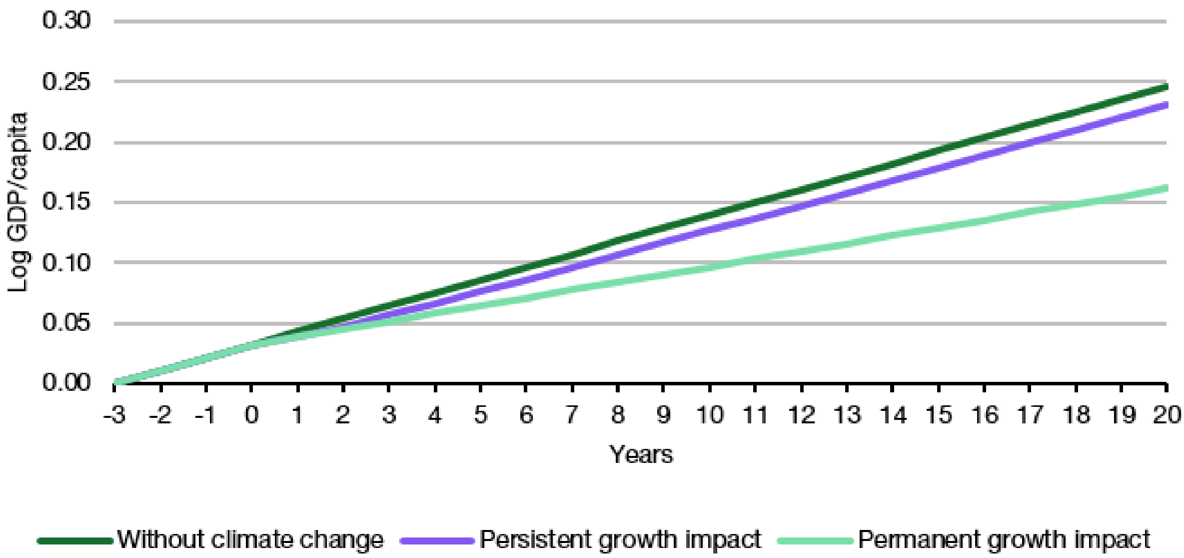
But when it comes to the economic impact of these temperature changes, our models are still evolving. The first models, developed by Nordhaus and his collaborators were simple models that did not include nonlinear effects, feedback loops, and tipping points in our climate and thus came to the conclusion that the GDP impact of climate change by the year 2100 will likely be in the low single digits.

Because of their shortcomings in capturing nonlinear effects, these projections can only be called a lower limit for the economic costs of climate change. I have discussed in this previous post what happens when you ask experts to assess the likely costs of climate change to the economy today. In short, the consensus impact on output seems to be in the order of 5% to 7% globally.

However, there is an important question that is still being debated and that has recently been tackled from a new angle by Ishan Nath and his colleagues: Is climate change going to reduce economic growth permanently or just temporarily.

This is an important distinction as the illustration below shows. If climate change leads to a permanent reduction in economic growth, then the long-term costs of climate change will become larger and larger over time. However, if the growth shock from climate change is persistent, but can eventually be overcome by technological progress and humans adapting to climate change, then we will still lose some output, but in the long run, these output losses will stop, and we evolve on a parallel track to the original growth path.

Persistent vs. permanent growth impact of climate change



Source: Liberum.

In their research, Nath and his co-authors build an economic model for climate change that includes several important real-life features. First, the model is a nonlinear model that allows for climate change to have effects that can grow faster and faster the more extreme they become. Second, the model allows for technology transfer and know-how transfer between countries, i.e. technology to adapt to climate change can be invented in one place and then 'diffuse' to other countries over time. This is obviously what happens with new technologies all the time. It's highly unrealistic to assume a technology will be kept to one company or one country forever.

But if we assume these two key facts (nonlinear, tipping point effects of climate change and slow adoption of technologies internationally), then one can show that climate change most likely has a persistent, but not permanent effect on economic growth.

To put it bluntly, higher temperatures and more extreme weather triggered by climate change lead to economic disruptions, be they floods, droughts, severe windstorms, etc. These disruptions reduce economic output in the year they happen, but then the economy starts to recover. Of course, the next year another disruption may appear, knocking the economy off course once more, etc.

Eventually, we develop technologies to mitigate these effects and adapt to a hotter, more volatile world. And the technologies that allow us to adapt to climate change spread from high-income countries where they are most likely to be invented to middle-income and finally low-income countries over time. Empirical evidence points to a persistence of climate shocks of about 8 to 10 years before growth resumes its original trajectory.

It is this effect why I think the real investment opportunity in ESG investing is not so much in climate change mitigation technologies like renewable energy anymore but in climate change adaptation, where much more investment is needed and where much more can be done to deal with the long-term impact of climate change.

When it's all said and done, the authors of the new study estimate that the amount of economic output lost by 2100 will be around 11.5% of global output per degree centigrade of global warming. This means with the global climate being on track to a 2.5 degree warming, the economic costs could be somewhere around 2.5 * 11.5% = 28.75%.

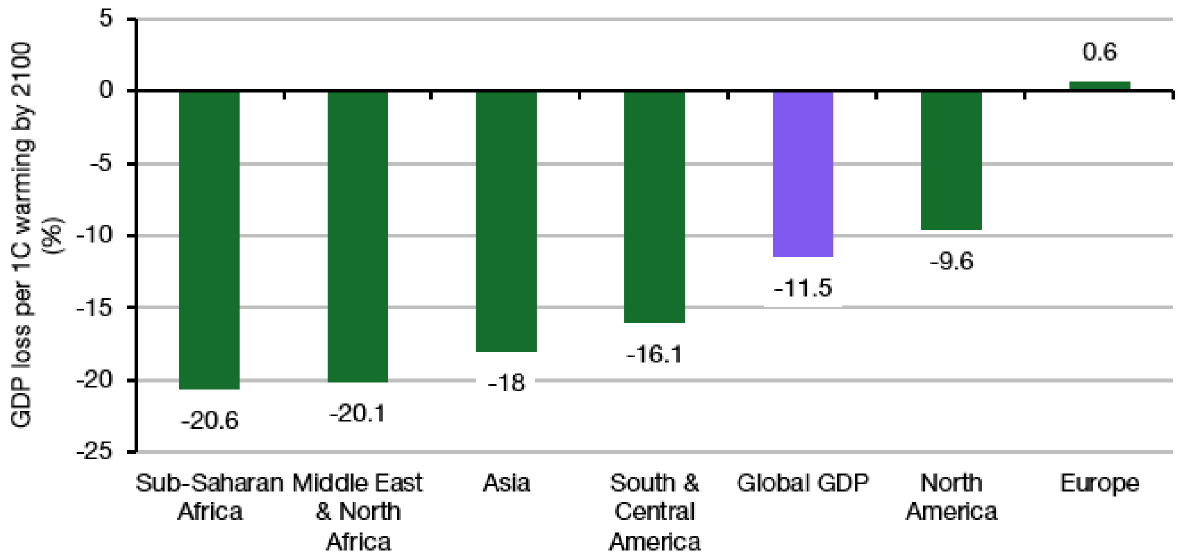
However, as always, the losses are not distributed equally. Countries closer to the poles will benefit economically from climate change, mostly because their winters get shorter and their summers longer, allowing for agriculture to cultivate more land and have better harvests. Similarly, businesses like construction or travel and leisure that rely a lot on outdoor work can produce more during a year since shorter winters reduce the time spent idle.

This means that Europe will feel little economic impact from climate change. At least on average. Obviously, the winners are countries like Norway or Sweden in the North of the continent while Spain or Italy will feel substantial negative impacts.

North America will also feel an economic impact less than the global average. Again, here Canada will likely benefit on average from climate change while Mexico and the southern parts of the US will feel a significant negative impact.

But the largest negative impact economically will be felt across Africa, where estimated economic damages by 2100 will be twice as large as the global average. And now consider what this means for global migration flows, geopolitical stability in the region and other geopolitical developments. If you think Europe or the US have a migrant crisis today, just wait a decade or two…

Estimated economic losses by 2100 per degree of global warming



Source: Nath et al. (2023)

Joachim Klement is an investment strategist based in London. This article contains the opinion of the author. As such, it should not be construed as investment advice, nor do the opinions expressed necessarily reflect the views of the author's employer. Republished with permission from Klement on Investing.

How super members can avoid missing out on tax deductions

Julie Steed

Claiming a deduction for personal super contributions can reduce personal tax and increase retirement savings, but there are many traps for the unwary.

Misunderstanding the eligibility rules can mean a member isn't able to claim all (or even any) of the contribution(s) as a tax deduction.

In this article, we explain the requirements for being able to successfully claim a tax deduction for personal super contributions.

Notice of intent to claim

To claim a tax deduction for personal super contributions, a member needs to submit a valid notice of intent to claim a tax deduction to the trustee of the fund. The notice is often known as a section 290-170 notice, which is the section of the tax law that covers deductible contributions. The form is available on the Australian Taxation Office (ATO) website - NAT 71121.

Many funds have their own form, but all are required to accept the ATO form.

General conditions

Conditions for claiming a tax deduction for personal contributions include:

- the individual is still a member of the super fund at the time of lodging the notice
- the relevant contributions are retained within the fund (ie they haven't been partially or fully withdrawn or rolled over from the fund)
- the trustee hasn't begun to pay a pension based in whole or part of these contributions
- the member hasn't supplied a super splitting notice to the fund in respect of the same financial year
- no part of the contribution(s) are covered by an earlier notice, and
- the member has received a notice of acknowledgement from the trustee of the super fund.

! Many SMSF trustees overlook the requirement to acknowledge the notice of intent (given their close association with the member) but the acknowledgement is required.

Timeframes

The notice of intent to claim a tax deduction must be submitted on or before the first of the following dates:

- the date the member submitted their tax return, and
- 30 June of the following financial year after the member made the contribution(s).

Work test

Members who are age 67 to 74 at the time the contribution is made need to meet the work test in the financial year in which the contribution is made. To meet the work test, the member needs to have worked at least 40 hours over a 30 consecutive day period.

Alternatively, members may be able to use the work test exemption if:

- their total super balance at the previous 30 June was less than $300,000
- they met the work test in the previous financial year, and
- they have never previously used the work test exemption.

Impact of partial withdrawals and rollovers

Where a member makes a partial withdrawal (including a rollover) during the year, part of the withdrawal is defined as including contributions made before the withdrawal. This means that unless a notice of intent to claim a tax deduction is received prior to a withdrawal, the member won't be able to claim a tax deduction for all of the personal contributions made that year.

A valid notice of intent to claim a tax deduction will be limited to a proportion of the tax-free component of the superannuation interest that remains after the roll over or withdrawal. The proportion is the value of the relevant contribution divided by the tax-free component of the superannuation interest immediately before the partial withdrawal.

The tax-free component of the withdrawal is:

$$\text{Withdrawal amount} \times \frac{\text{tax-free component of interest before withdrawal}}{\text{value of super interest before withdrawal}}$$

The tax-free component of the remaining interest is:

$$\text{Tax-free component of interest before withdrawal} - \text{tax-free component of withdrawal}$$

The remaining amount of the personal contribution is:

$$\text{Tax-free component of remaining interest} \times \frac{\text{personal contribution}}{\text{tax-free component of interest before withdrawal}}$$

Some members use regular rollovers to fund insurance premiums in an insurance only super fund. In some instances, members may not be fully aware of the impact on their ability to claim a tax deduction, as the case study below illustrates.

Members can avoid having the amount of the personal contribution that can be claimed as a deduction reduced if they lodge the notice of intent to claim a tax deduction before they request the partial withdrawal or rollover.

Case study

Chai contributes $2,500 per month to super and intends to claim $30,000 as a tax deduction in 2024/25. On 31 December 2024, Chai rolls over $3,000 to pay for annual insurance premiums in an insurance only super fund. Chai doesn't provide the super fund with a notice of intent to claim a tax deduction before the rollover.

As at 31 December 2024, Chai's super balance is $100,000 and the tax-free component is $15,000 (the contributions for which a notice of intent to claim a tax deduction hasn't been received by the fund).

The tax-free component of the rollover is:

$$\text{Roll-over amount} \times \frac{\text{tax-free component of interest before rollover}}{\text{value of super interest before rollover}}$$

$$\$3{,}000 \times \frac{\$15{,}000}{\$100{,}000} = \$450$$

The tax-free component of the remaining interest is:

$$\text{Tax-free component of interest before rollover} - \text{tax-free component of withdrawal}$$

$$\$15{,}000 - \$450 = \$14{,}550$$

The remaining amount of the personal contribution is:

$$\text{Tax-free component of remaining interest} \times \frac{\text{personal contribution}}{\text{tax-free component of interest before rollover}}$$

$$\$14{,}550 \times \frac{\$15{,}000}{\$15{,}000} = \$14{,}550$$

Chai contributes a further $15,000 before the next 30 June. Chai then lodges a notice with the intention to claim a deduction for the total of $30,000 contributed in 2024/25. The notice is not valid as the super fund only holds $14,550 of the first half of the year's personal contributions. Chai can only lodge a valid deduction notice for an amount up to $29,550.

Chai could claim the whole $30,000 by lodging a notice of intent to claim a tax deduction of $15,000 before the rollover occurs, and a second notice for the subsequent $15,000.

Multiple withdrawals

Multiple withdrawals/rollovers further complicate the calculations and further reduce the amount of contributions for which a tax deduction can be claimed. In addition, transactions in the following financial year may reduce the amount available to be claimed.

! Partial withdrawals made in the following financial year but before the notice of intent to claim a tax deduction is lodged can further reduce the amount that can be claimed.

Conclusion

Understanding the eligibility requirements for claiming a tax deduction for personal contributions will enable members to maximise their tax deductions. The calculations are complex and not necessarily intuitive.

Any members who make partial withdrawals should seek financial advice regarding the amount that can be claimed. However, lodging a notice of intent to claim a tax deduction prior to requesting any partial withdrawal will maximise the amount that can be claimed.

Julie Steed is a Senior Technical Services Manager at MLC TechConnect. This article provides general information only and does not consider the circumstances of any individual.

AI is not an over-hyped fad – but a killer app might be years away

Dr Kevin Hebner

The adoption of artificial intelligence (AI) has driven huge gains in the US stock market over the past 18 months led by the greatest beneficiary of all, semiconductor company, Nvidia. The AI theme is likely to be an enduring one with winners including the biggest technology companies, as they are able to invest massive amounts of cash in this emerging technology.

Yet as AI takes the world by storm, policymakers face a significant challenge in regulating AI as innovations quickly expand and citizens across the globe demand action to ensure the rollout of AI balances the enormous opportunities touted by true believers with the real and perceived risks emphasized by the vast majority of people.

Despite these risks, big technology companies have turbocharged their efforts to develop AI models and applications. In many cases they appear more interested in speed than safety, following the adage of "move fast and break things." This is not surprising given the winner-takes-most nature of digital tech and AI. However, the public wants increased transparency and is demanding thoughtful regulation. However, regulators need to "skate to where the puck is going" and that is not at all clear at this point.

There are lots of ways to mess up regulating a new technology

The history of regulation suggests one major risk is a rush to act, without considering the full benefits of AI technology. As often occurs, regulators may inflict a lot of harm in an attempt to do a little good.

One key risk is strangling innovation, as frequently transpires, particularly in Europe. Another risk is regulatory capture, which seems especially likely in the US given the high stakes and dearth of AI expertise in government. A third risk is state dominance, as is occurring in China. There are lots of ways to mess up regulating a new technology.

In terms of encouraging innovation, the US is usually much more effective than Europe and other economies. "American exceptionalism" largely reflects its light regulatory touch and unrivalled venture capital ecosystem. And this helps explain why most top AI professionals chose to work in the US, even among those born abroad. It also clarifies why America captures the lion's share of private sector investment in AI.

When it comes to regulation, history shows us that mistakes are likely to be made, and they will have important implications for the pace of innovation, the structure of the tech industry and the cash flow accrued by investors. While there are also risks to insufficient regulation, the track record with digital tech makes it clear that premature implementation of a rigid and complex regulatory framework is likely to impose excessive costs but do little to protect society.
Some commentators quip that "AI will be the first industry to be regulated before it becomes an industry." With new technologies, it usually takes ten to twenty years before a regulatory framework is put it place. This reflects the fact that nobody possesses a crystal ball, so we do not know which startups will become the next titans, and which current superstars will fall. This level of uncertainty means governments need to proceed cautiously before introducing restrictive laws regulating new technologies and halting progress.

Moreover, we believe AI represents the fourth wave of digital technology following the PC, internet, and mobile phones. Overregulating this emerging technology would harm the pace of technological development, damaging innovation, productivity, economic growth, and national security.

Winners from the AI movement

Digital tech always features winner-takes-most dynamics and AI will not prove an exception. This means aspiring titans need to move fast and invest massively. There is room for only a small number of winners in each segment and those companies will reap the vast bulk of free cash flow and profits going forward.

One computer chip design company illustrates this dynamic. Nvidia has led the AI gains to become almost as large as Microsoft and Apple, momentarily becoming the largest company in the world in mid-June. But Nvidia's price now assumes that it will grow earnings by 20% a year for the next 18 years. Other companies have done that - Apple did it, Microsoft did it. But they did it when they were much smaller companies. This makes us sceptical regarding future returns for Nvidia's shareholders. We are similarly sceptical about Tesla.

Our preference is to seek companies with a return on invested capital (ROIC) well above their weighted average cost of capital (WACC). We also look for high and sustainable operating margins and a solid track record of generating free cash flow (FCF). Regarding valuations, we want to be confident that the earnings growth already incorporated in the share price seems reasonable and attainable. From this perspective, AI leaders such as Microsoft, Google and Meta are interesting.

Other potentially interesting companies include Taiwan Semiconductor Manufacturing Company (TSMC), the Taiwanese contract manufacturing company. It fabricates the vast majority of leading-edge chips, including those designed by Nvidia.

Semiconductor equipment company, ASML is also interesting. Dutch-based ASML has overtaken the French luxury giant LVMH as Europe's second largest company, second only to drug maker Novo Nordisk. ASML has for a time been Europe's largest technology company, making the lithography machines that are critical to chip manufacturing. It possesses a near monopoly in this segment, a result of almost four decades of intense research and development.

Education and healthcare are among the sectors to benefit from AI

Healthcare is one industry where we see AI having tremendous impact. Healthcare is about 20% of U.S. gross domestic product (GDP), and a similar percentage of employment. There are many areas where AI can be used in the sector, including transcribing doctors' notes, diagnosis and assisting radiologists, as well as drug discovery and the invention of new antibiotics. The challenge with the healthcare sector though is that it's highly regulated and institutionalised, which sometimes makes it quite resistant to change.

Another sector likely to benefit is education. A company called Khan Academy, run by Sal Khan, has an AI application called Khanmigo, and it's currently being rolled out in a small number of schools. This is a terrific development, as it enhances the education process and gives every student an AI tutor focused on their needs, interests, and pace of learning. AI will also change the role of teachers, who will spend less time lecturing and grading papers and more time supervising, monitoring, helping students when they get stuck, and overall acting like a conductor.

AI will also have dramatic impact on the entertainment industry, including music and video generation. OpenAI's Sora application, for example, focuses on creating animated content, in some cases reducing the cost of producing animation by 99%. This will create challenges for places like Disney and Netflix, but ultimately, we're going to be able to enjoy even more quality content than we have today.

Ted Sarandos, the co-CEO of Netflix, argues AI is just another tool to help them tell stories that people love. We agree and believe the best way to think about AI is that it augments our abilities. This is true for healthcare professionals, educators, creative workers, and people in the finance sector. Whether you are a financial analyst, a portfolio manager or an advisor, AI is a tool that complements your abilities, enabling professionals to be even more effective and productive. Overall, AI is likely to be a net positive for many roles, as it augments what professionals do on a day-to-day basis.

To conclude, AI is likely to be the key investment theme for at least the next decade. This presents many opportunities for investors, as well as a number of challenges. One of these is that there's usually room for only a small number of winners in each segment and those companies get the vast bulk of free cash flow and profits going forward. This means increased market concentration, which is an integral feature of digital tech and AI. A second challenge is that a killer app might be years away which suggests significant market volatility going forward.

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Why certainty is so important in retirement

Justine Marquet

Extensive research has been conducted into retiree concerns, with three key concerns consistently coming out on top:

1. running out of money
2. facing unexpected health and aged care costs
3. not being able to maintain a comfortable standard of living in retirement.

In other words, not knowing what’s waiting for us in the future – or uncertainty.

Uncertainty is impacting quality of life in retirement

The investment strategies and products that have served so well in accruing assets via super don’t necessarily provide the kind of financial certainty Australians want (and need) in retirement.

It doesn’t help that super has long been framed as a ‘nest egg’ to fund our retirement – a label that is hard to shake off in the retirement phase. After being told all our working lives to grow our savings for retirement, studies show that many retirees are reluctant to draw it down, opting instead to spend less and preserve as much of it as possible in the face of an uncertain retirement timeframe.

The upheavals of recent years have also played a significant role in the diminishing drawdown of savings that we are seeing. Uncertainty about market volatility, about inflation and the cost of living, uncertainty about unplanned future expenses – all of these influence a person's financial confidence going into retirement.

Ultimately, this has a tangible impact on the quality of life in retirement; not only is uncertainty depriving many older Australians of a lifestyle they can actually afford, but the considerable financial concerns carried into post-work life impacts their physical, mental and emotional wellbeing.

The current approach to retirement income

Today, more than ever, retirees want the confidence to spend and enjoy the continuity of their lifestyle. For this, they need certainty and flexibility from their investment strategies, as well as solutions to the unpredictable financial outcomes they'll likely face in retirement.

At one end of the spectrum, account-based pensions provide flexibility but can leave retirees shouldering significant investment and longevity risk and fail to fully address the financial fears held by retirees.

At the other end, traditional lifetime annuities involve trade-offs between income certainty and flexibility and are often limited in terms of how one can invest, withdraw or use their money.

The Age Pension, upon which many Australians rely once their retirement savings are exhausted, barely provides enough income to sustain a subsistence level of retirement.

As life expectancies increase and living costs rise, the strategies and products currently available are becoming less effective in addressing the need for certainty. With the retirements of 4.2 million plus Australians[1] at stake, new and innovative income solutions are urgently needed to complement existing products and strategies. Next-generation income solutions that provide certainty.

Rethinking income sources in retirement

A 2022 Actuaries Institute report[2] noted that combining traditional products with innovative solutions could lead to a remarkable 30% increase in retirement income.

Further, the report noted that methods, such as using investment-linked lifetime income streams, have been shown to lift retirement income without increasing longevity risk: a win-win outcome that would see Australian retirees benefit from larger payments and a better quality of life without increasing the likelihood of outliving their savings[2].

The next generation of retirement products must improve on earlier efforts, with outcome-oriented solutions designed around core features, including:

Protected growth	Retirees can benefit from growth and a downside protection mechanism limiting risk exposure, while offering the potential for the capital growth necessary to fund longer retirement periods.
Guaranteed lifetime income	Backed by regulated life companies with strong balance sheets and capital reserves, guaranteed income payments will be paid for the life of the retiree.
Flexible access to savings	Retirees can withdraw all or part of their account balance at any time so that unexpected expenses can be quickly and easily met
Control	A range of investment and protection options to suit investors as their needs and tolerance to risk changes.
Seamless integration	Integration into a super fund or an ABP will make administration easier for retirees, financial advisers and super funds.
Investment value payable on death	Retirees can leave their residual investment value to beneficiaries.

Recently, we have seen an emergence of innovative retirement solutions designed to pay a guaranteed income for life with more flexibility in their design. These next-generation lifetime income solutions have been designed to provide income certainty, flexibility, and the ability to access capital whenever needed.

Australians should be able to live their lives with certainty and not have to worry about tomorrow's 'what ifs', market volatility or whether they'll have enough money for the future.

Justine Marquet is Head of Technical Services at Allianz Retire+, a sponsor of Firstlinks. This article is for general information only and does not take into account your objectives, financial situation or needs. For personal financial advice please speak to your financial adviser.

Allianz Guaranteed Income for Life (AGILE) is a next-generation retirement income solution that delivers certainty in the form of a guaranteed income for life. To learn more, visit www.allianzretireplus.com.au/about-us/certainty.

[1] Australian Institute of Health and Welfare, 'Older Australians', 20 November 2023.
[2] Actuaries Institute, 'Actuaries develop a framework for maximising retirement income', 26 April 2022.