Firstlinks
a Morningstar company

Edition 586, 15 November 2024

Contents

Coalition's super for housing plan is better than it looks   Noel Whittaker

Avoiding wealth transfer pitfalls   Peter Nevill

More people want to delay retirement and continue working   ASFA

US debt, the weak AUD and the role of super funds   John Abernethy

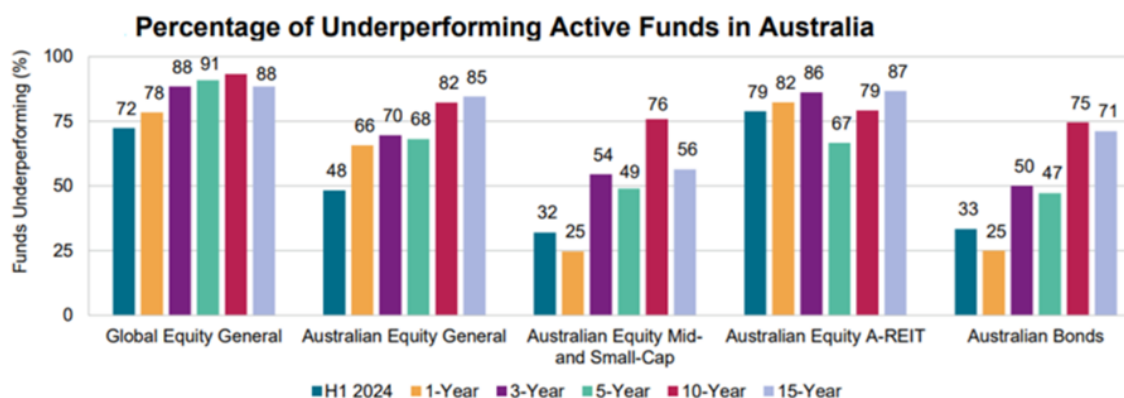
America eats the world   James Gruber

What's next for gold?   John Reade with James Gruber

Consulting on the side? Don't fall into these tax traps   Peter Bembrick

Editorial

In recent years, fund managers have received a lot of bad press for their performance versus benchmark indices. In an editorial in October, I wrote of S&P Global's new SPIVA report, which showed Australian fund managers performed better in the first half of the year, with most outperforming indices in local equities, small and mid-caps, and bonds. But their results were less impressive over longer periods.

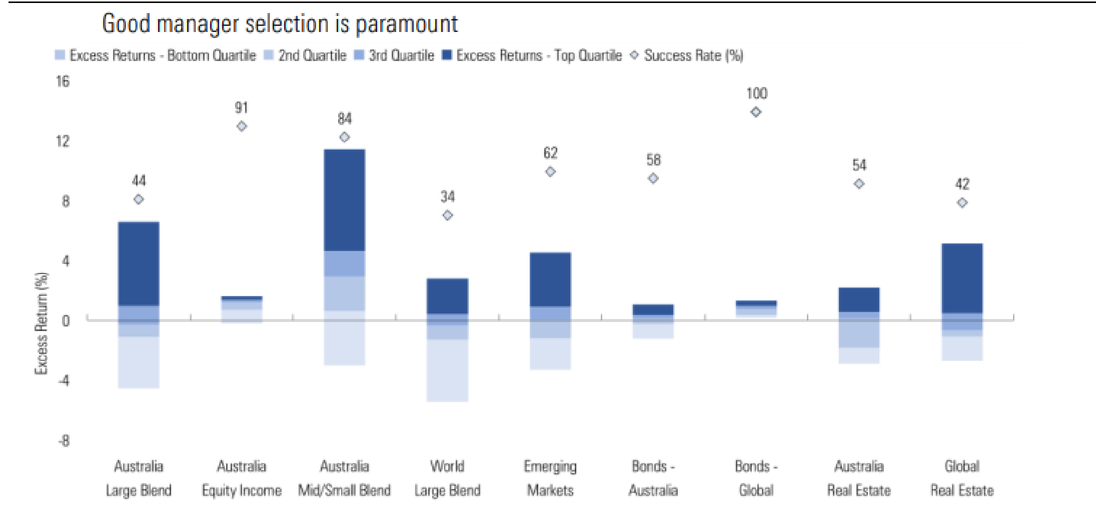


Source: S&P Dow Jones Indices LLC, Morningstar. Data as of June 30, 2024. The back-tested data reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Active vs passive

In a new report, Morningstar has measured fund managers' success relative to the net-of-fee performance of comparable passive funds, rather than an index. And it turns out that active managers stack up pretty well.

The study spanned more than 800 open-ended fund strategies across nine different categories. It found that the top quartile performers in every category have generated positive excess returns over their passive counterparts in the trailing 10-year period.



Source: Morningstar Direct. Data as of June 30, 2024. Calculations for 10-year period ending June 30, 2024. Returns have been annualized.

Some categories of fund managers did better than others. In the prominent 'Australia Large Blend' category, active funds performed worse over the past 10 years, better over five years, and were evenly split in the prior three years. Put simply, large cap managers have had periods of outperformance and underperformance.

Morningstar Category: Australia Large Blend

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Large Blend	3Y	5.6	6.1	-0.5	50	83
Australia Large Blend	5Y	6.9	6.9	0.0	61	76
Australia Large Blend	10Y	7.5	7.6	-0.1	44	71

Source: Morningstar Direct. Data as of June 30, 2024. Returns have been annualized for periods exceeding one year.

Mid and small cap managers fared better. They performed in line with passive funds over three years, but significantly outperformed over longer periods. And, most of these managers beat passive across every timeframe.

Morningstar Category: Australia Mid/Small Blend

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Mid/Small Blend	3Y	0.4	0.4	0.0	65	92
Australia Mid/Small Blend	5Y	8.5	5.0	3.5	80	90
Australia Mid/Small Blend	10Y	9.5	6.7	2.8	84	74

Source: Morningstar Direct. Data as of June 30, 2024. Returns have been annualized for periods exceeding one year.

This would suggest that there's value in managers who can find pricing discrepancies in relatively under-researched mid and small caps.

Similarly, Australian equity income has been a favourable area for active managers. They've had excess returns across all timeframes.

Morningstar Category: Australia Equity Income

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Australia Equity Income	3Y	6.2	5.0	1.2	83	100
Australia Equity Income	5Y	6.3	5.4	0.9	81	100
Australia Equity Income	10Y	6.5	5.5	1.0	91	100

Source: Morningstar Direct. Data as of June 30, 2024. Returns have been annualized for periods exceeding one year.

Most dividend-focused passive funds have strict rule-based mandates. It seems that active funds with more flexibility can generate significant outperformance in this space.

Investing overseas has been more of a problem for Australian equity managers. In the 'World Large Blend' equity category, passive dominates active funds. Undoubtedly, increasing market concentration, aka 'The Magnificent Seven', has made it more difficult for active managers to keep up with the performance of comparable passive funds.

Morningstar Category: World Large Blend

Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
World Large Blend	3Y	7.2	8.6	-1.4	44	83
World Large Blend	5Y	10.1	12.3	-2.2	22	77
World Large Blend	10Y	11.4	12.0	-0.5	34	77

Source: Morningstar Direct. Data as of June 30, 2024. Returns have been annualized for periods exceeding one year.

In fixed income, fund managers have added value both in Australian and global bonds. In local bonds, most managers have beaten passive counterparts over three, five and 10 years. Excess returns have been more positive in recent years with the normalization of the yield curve.

Morningstar Category: Bonds—Australia

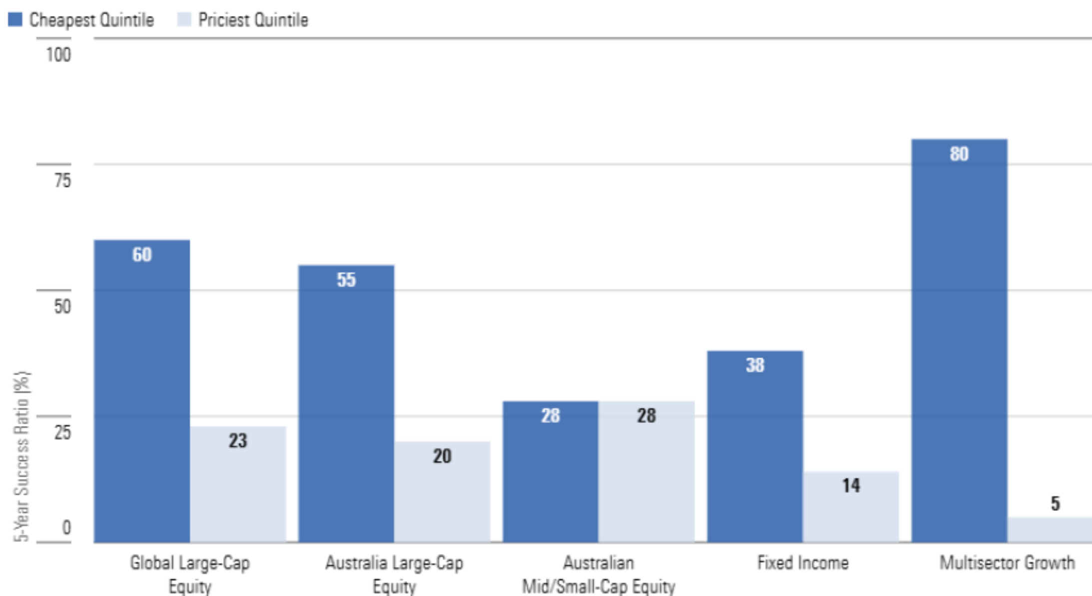
Category	Time Period	Active Funds Average Return (%)	Passive Funds Average Return (%)	Excess Return (%)	Active Funds Success Rate (%)	Active Funds Survivorship (%)
Bonds - Australia	3Y	-1.1	-2.3	1.2	75	89
Bonds - Australia	5Y	0.0	-0.8	0.8	79	87
Bonds - Australia	10Y	2.0	1.9	0.0	58	79

Source: Morningstar Direct. Data as of June 30, 2024. Returns have been annualized for periods exceeding one year.

Managed fund fees are a key predictor of future returns

In a separate report, Morningstar has updated previous work which showed that fees were a reliable predictor of the future success of a fund.

The report confirms that lower-cost funds in Australia have a greater chance of outperforming their more expensive peers, as the chart below indicates.



Source: Morningstar Direct. Data as of June 30, 2024.

In four out of five categories, the cheapest quintile of funds, both managed and passive, produced better results than the priciest quintile over the trailing five years.

Breaking that down further, in Global Large-Cap Equity, 68% of the funds in the lower quintile of fees outperformed their category group. These funds had average expense ratios of 0.46%. And their average annualized total return was 11.73% in the five years to June 30, 2024.

That compares to funds in the highest quintile of fees, where only 23% beat the category group, with average annualised returns of 8.05%, and expense ratios of 2.58% being a key drag on performance.

In Australian mid and small cap equity, fees weren't as big a factor in overall results. The success ratio of the cheapest and priciest quintile was equal at 28%. Perhaps this suggests cheaper isn't better when it comes to selecting small cap managers, and it may be worth paying up for good ones.

Fees were a larger factor for fixed income managers. Yet the spread between the cheapest quintile's success ratio and the most expensive was smaller than for other asset classes. The cheapest quintile's success ratio of 38% compared to the 14% of the priciest quintile.

The report says that active managers in fixed income tend to underperform indices in risk-off conditions while outperforming in more sanguine markets. That's because the managers tend to overweight corporate credit relative to the index, where conventional benchmarks have a considerable skew to government and government-related bond issuance. The report goes on to suggest that "although active fixed income managers are often able to outperform the index gross of fees, the outperformance does not always compensate for the corresponding fees."

The largest disparity between the cheapest and priciest quintile of fund managers was in the multisector growth category. Here, the cheapest quintile recorded a success ratio of 80% compared to the most expensive quintile's 5%. The dispersion in fees was comparable to other asset classes with the cheapest charging an average 0.56% compared to the dearest's 2.53%.

In sum, cost is a big predictor of managed fund returns and should be a key consideration for investors.

Thanks to the relentless rise of the tech giants, America now accounts for a record high 66% of the MSCI world equity index. My article this week exmaines who America came to dwarf other markets, and what could change to slow or halt its momentum.

James Gruber

Also in this week's edition...

Housing affordability is likely to take centre stage as we head towards the next federal election. The Coalition has copped a lot of flak for its super for housing plan but **Noel Whittaker** thinks it has a lot of merit, albeit it's missing one key feature that could be a game-changer.

The transfer of wealth between generations is a pressing issue in Australia, with an estimated $3.5 trillion expected to be passed down from those aged 60 and over in the next 20 years. **Peter Nevill** presents a case study highlighting some of the challenges and opportunities with this shift in intergenerational wealth.

A new survey from **The Association of Superannuation Funds of Australia** suggests that most people aged 50 or over don't intend to stop work completely when they reach retirement age. And a significant proportion of those who delay retirement do so for non-financial reasons.

The relentless strength of the US dollar should be getting much more attention than it currently is, **Clime's John Abernethy** thinks. He says it shows that the US economy is excessively calling upon and draining the developed world's capital. That's bad news for countries outside of America, including for Australia.

Gold has had a minor pullback after a ripping run this year. The rise in the yellow metal's price has happened despite a surge in the US dollar and fall in global inflation. So, what has driven the price over the past year or two, and what could happen next? **The World Gold Council's John Reade** gives us his insights.

A growing trend in recent years has been for experienced employees to develop what is known as a 'patchwork career', where they take on a number of roles, including consultancy work, as part of their transition to retirement. While it can be an attractive option, **Peter Bembrick** says there are some traps to be aware of, particularly when it comes to tax.

Lastly in this week's whitepaper, **First Sentier** explains how US utilities are ahead of the curve on decarbonisation and well on their way to achieiving net zero emissions.

Coalition's super for housing plan is better than it looks

Noel Whittaker

Housing affordability is shaping up as a major topic as we head toward the next federal election. The numbers are staggering. Ten years ago, the median house price in Sydney was $880,000, and in Melbourne it was $630,000. Today, those figures are $1.7 million and $1.2 million respectively. This equates to an annual increase of 7.93% for Sydney and 6.8% for Melbourne.

Meanwhile, wages have not kept pace. Over the last decade, gross income growth has averaged just 2.18% per year for Sydney and 2.03% for Melbourne. This disparity is continuously widening the gap between the haves and the have-nots. Children of well-resourced parents have been able to enter the market by drawing on the Bank of Mum and Dad, and this demand has driven prices up further, making affordability even harder for those without such support.

The housing market today faces many challenges, all connected and making the problem worse. A sharp rise in migration has led to greater demand for properties, putting pressure on an already tight market. At the same time, there is a growing shortage of skilled workers and building materials, slowing down the construction of new homes. Militant unions pushing for higher wages are also driving up building costs.

Bureaucratic delays add even more problems. Red tape, slow approvals, and the rising costs of regulation make it difficult to start new housing projects. And here's the catch-22: government incentives meant to help first homebuyers—like reduced stamp duty and special deals—often have the opposite effect. These measures increase demand, which puts more pressure on the market and drives prices up, making homes even less affordable in the long run.

Yet another hurdle is mortgage insurance, which is required for buyers with less than a 20% deposit. For example, analysis from Mozo.com.au shows that if you bought an $850,000 property with a 5% deposit of $42,500, the lender's mortgage insurance fee would be almost $38,000 – nearly as much as your deposit.

To make matters worse, mortgage insurance is not transferable from one lender to another, even though there are only a few providers in the country. This makes it virtually impossible for anyone with less than 20% equity to refinance their property with a different lender on better terms, because they would need to pay for mortgage insurance all over again.

The Coalition proposes a unique scheme that allows homebuyers to invest up to $50,000 or 40% of their superannuation (whichever is less) toward the purchase of a new or established home. I have been dead against previous suggestions to draw on super, because of the long term detrimental effect on people's balances, but this scheme has a way to deal with that. Participants are required to refund the withdrawn amount, along with any earnings, when the house is sold. The "interest" rate used to calculate the earnings will be tied to the capital growth of the home.

This scheme will also be available to people who separate later in life, especially to assist women into home ownership, noting the current income and employment gaps compared to men. Participants must live in the property as owner-occupiers for at least 12 months and provide a minimum deposit of 5% of the purchase price, excluding the amount withdrawn from their superannuation. Upon selling the property, they must repay the withdrawn funds along with any proportional gains or losses.

Think about Kerry and Sam, both aged 35, who each have $84,000 in superannuation. Through diligent saving, they have scraped together a deposit of $85,000. But if they buy now, they'll be liable for nearly $21,000 in mortgage insurance, which will be added to their loan and remain a burden for the life of the loan. However, if they chose to withdraw $36,000 each from their superannuation under the proposed Super Home Buyer Scheme, the mortgage insurance would drop to just $6700. If they focused on paying off the mortgage quickly, in a few years they may be able to get the loan to valuation ratio below 80%, and then be free to refinance at a cheaper interest rate. The ability to access their superannuation has saved them over $14,000, which is a massive return on the $72,000 they have borrowed from their super.

This case study shows the benefit of the superannuation access scheme. Using super funds reduces the loan size, improving loan-to-valuation ratios, and potentially improving eligibility, especially if income is limited. And a smaller loan can be paid off faster, using simple techniques like fortnightly repayments.

If the property appreciates by 3% annually and they sell in five years, the $36,000 each has borrowed from super must be repaid, plus a 3% notional interest matching the capital gain. This strategy helps build financial security by reducing loan interest and increasing property equity through capital growth. The Coalition needs to add just one feature: make mortgage insurance transferable between lenders. This would be a game-changer.

Noel Whittaker is the author of 'Retirement Made Simple' and numerous other books on personal finance. See noelwhittaker.com.au. This article is for general information only. Noel's latest book, Wills, death & taxes made simple, is available now.

Avoiding wealth transfer pitfalls

Peter Nevill

Audrey* enjoyed a rewarding life. Her devoted husband, Frank, passed a few years ago – they had built their wealth over a lifetime together and ensured Audrey was financially secure. She has two successful sons and five grandchildren. In her late 80s and in failing health, she could take comfort from the fact her financial affairs had been structured to maximise the benefits for her family for generations to come.

Following Frank's passing, Audrey's assets were held across both their longstanding SMSF, and a substantial portfolio held in her name. Audrey understood the importance of having conversations with their sons about her wishes and having them involved in the structuring of her estate in preparation for the transfer of wealth.

While this task was made easier from being a close family unit, it still required lengthy discussions to ensure the best outcome - highlighting the value for all families with wealth to be inherited of having plans in place early to ensure assets pass prudently and equitably.

In dealing with people who have very real hopes and fears, intergenerational wealth transfer is not just about what makes sense through a dispassionate, mathematical lens – it must reflect the clients' wishes and values around their family and legacy.

This type of forward-thinking planning is crucial, particularly as Australia is in the early throes of the intergenerational wealth transfer, that the Productivity Commission estimates will total about $3.5 trillion by 2050.

Family conversations are critical

Audrey had said that she and Frank, an accountant by profession, always encouraged money discussions with their boys from an early age. In many families, this topic can often be taboo.

But by having these conversations, parents can have greater comfort that their wishes will be respected (remember, wills can be successfully challenged in the court system), and the recipients better understand not only the financial fundamentals, but the gravity of inheriting significant wealth.

It's critical that it does happen – for two key reasons. Firstly, with former generations, the quantum of wealth shifts wasn't nearly as pronounced. The baby boomer generation (1946-64) is the first generation where wealth is far more widespread due to property prices and, to a lesser extent, compulsory superannuation. So, the need for these discussions is more important than ever.

Secondly, it's a reality that basic financial education is sadly lacking in the school system. For those families with a financial adviser, there's the opportunity include all family members in the discussion. But this is a minority, meaning the onus is on the family to impart this critical skill set on to their children.

Asset allocation needs to be considered

Investment considerations are also a key component. Audrey's eldest son, John, has a more balanced investment approach, more aligned with his late father's penchant for fully-franked Australian blue-chip shares, while his sibling Nicholas, five years his junior, has a greater interest in assets with a higher-risk, higher-return investment dynamic.

Although the brothers have differing ideas on investment, they appreciated and understood the foundations of investing courtesy of the many family discussions about financial matters. Part of the wealth transfer process was the appreciation that as assets were passed down, the underlying investments and asset allocation of the capital would inevitably change to reflect the goals and time horizons of the adult sons and their families.

What did this look like in our example? Audrey had a substantial amount in superannuation via her SMSF and a significant personal portfolio. Due to Frank's conservative outlook, it was overweight large-cap Australian blue-chip shares and cash – given their stage of life, the fully franked dividends came with substantial tax benefits, and investors typically grow fond of holdings that have served them well through the years.

Remember also, markets are volatile. In the 21st century, we have had the Tech Wreck, the GFC, and COVID market meltdowns.

Regardless of life-stage, asset quality within portfolios is paramount in helping clients withstand market volatility and reducing the risk of impairment, as is the need to be diversified across both traditional and alternative asset classes in seeking to produce robust long-term outcomes and generate revenue through the economic cycle. In short, all the capital should not be exposed to all the same risks.

It's not just about adapting the investment style to each estate recipients' investment tolerances and prejudices; it is vital to utilise strategies to minimise the tax burden during the transfer.

What happened in Audrey's case

So, conscious her health was rapidly declining, an estate planning lawyer was brought into the fold with Audrey and her sons – seeking to ensure the optimal structure for the impending wealth transfer. What does that look like in practice? Her will was updated to establish a testamentary trust for each son upon her death. Audrey also withdrew her superannuation ahead of her passing to avoid any taxable component being taxed at 15% (plus Medicare levy).

When she passed, the assets were left to her sons in their testamentary trusts (a vehicle that the sons' entire families could benefit from), and portfolios customised within each trust. Generally, a discretionary (family) trust can be an excellent vehicle for transferring wealth. In addition to the tax-effective flexibility to distribute income and capital gains between beneficiaries, as its 'lifespan' is 80 years in most states, by planning the seamless transfer of control (i.e. the pre-determined ownership change of the corporate trustee shares, for

example) the portfolio within can endure in the same structure beyond the death of the matriarch or patriarch – in line with their wishes and without needing to sell assets and incur tax.

In Audrey's case, by adopting this approach, they avoided the real risk that many families confront on the passing of a loved one – no planning, no strategy to minimise the tax drag on the estate, and even no will. Tragically, it often means a time for genuine grief gets consumed by family disagreement over the estate. So much better to plan, especially with $3.5 trillion at stake.

** Family names have been changed*

Peter Nevill is an Adviser at [Viola Private Wealth](). This article has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

More people want to delay retirement and continue working

ASFA

This note explores the findings of a recent survey of Australians about superannuation and retirement. The survey comprised 1,500 adults – representative of the broader population in terms of age, gender, education and whether respondents reside in urban or regional areas. This note also utilises a range of data from the ABS.

Retirement pathways differ

There is no typical pathway to retirement.

Differences include the age at which people retire permanently from work, their work arrangements at the time of retirement, any changes to work arrangements in the period leading up to retirement, and the age at which they choose to access their superannuation.

While the decisions that shape retirement pathways certainly reflect financial circumstances, these are not the only considerations for many older Australians. Some people delay retirement and remain in the workforce to maintain social connections. Others retire earlier than they would like due to ill health or in order to care for family members – with the latter disproportionately impacting women.

Individual access to the Age Pension and super

In terms of financial circumstances, retirement decisions are framed by the ages at which individuals can access the Age Pension and/or their superannuation. Australian residents, once retired, can access the Age Pension from age 67. For individuals, their eligibility for the pension and their pension amount are determined by income and assets tests.

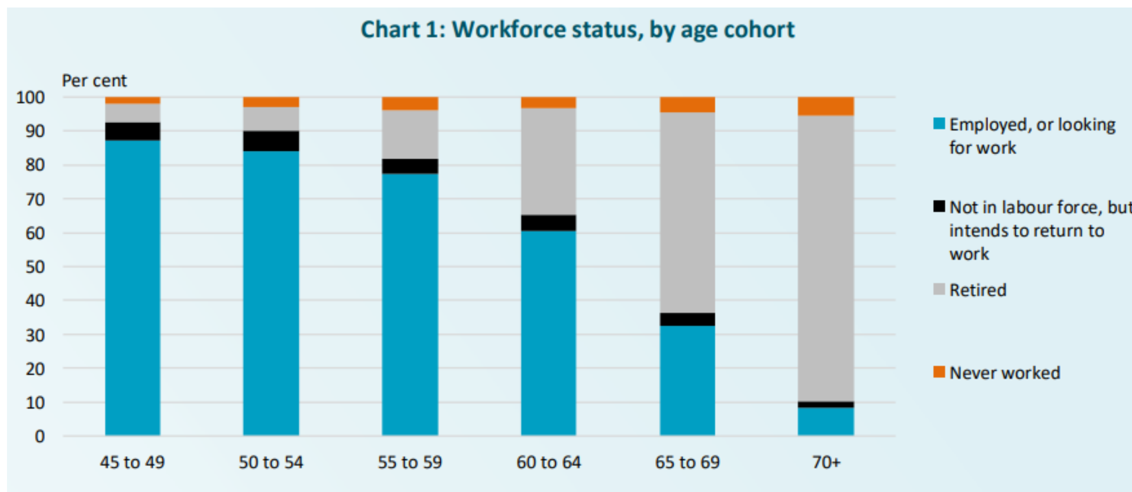
Typically, an individual's pension eligibility and the payment amount change during their retirement. Individuals can access their superannuation when they reach their 'preservation age' – for those born after 1 July 1964, this is age 60. Members of defined benefit superannuation schemes are often subject to an earlier preservation age.

This does not imply that an individual needs to retire to access their superannuation upon reaching preservation age. In particular, workers are able to access part of their super savings via a transition to retirement income stream (or "TRIS"), which enables them to reduce their working hours while topping up their income.

These settings provide flexibility for older Australians in their pathway to retirement and, more broadly, supports participation by older Australians in the workforce.

Many older Australians remain engaged in the workforce

For the population of Australian adults, Chart 1 below shows the variation in workforce status (which includes retirement), across and within age cohorts – where being "retired" specifically refers to people who have "ceased working and/or ceased looking for work".



Source: ABS, *Retirement and Retirement Intentions* and ASFA.

Note that the outcome for the 70+ age cohort comprises the (weighted) average of all 5-year cohorts older than 70. The outcome for the 70 to 74 age cohort (not shown) can be assumed to contain a smaller proportion of retirees, and a larger proportion of employed people, than the average.

Chart 1 shows that a substantial minority of older Australians delay retirement and remain engaged in the workforce.

For the cohort who are either employed or actively looking for work (the blue bars), this accounts for 33% of people aged 65 to 69, and 8% of people aged 70+. In addition, a small percentage of people are not currently in the labour force but want to work: 4% of people aged 65 to 69, and 2% of people aged 70+.

For these two older cohorts, Table 1 provides details of employment arrangements. In particular, it shows a general shift from full-time to part-time work through the two age cohorts. For all individuals who are employed, Table 1 reveals that:

- Full-time workers account for 16% of the 65 to 69 cohort, and 3% of the 70+ cohort.
- Part-time workers account for 16% of the 65 to 69 cohort, and 6% of the 70+ cohort.

Table 1: Workforce status, by age cohort*

	65 to 69	70+
Retired	58.9	84.4
Never worked	4.7	5.5
Employed: Intends to retire		
Full-time until retirement	4.8	0.8
To switch from full-time to part-time	4.7	0.5
Part-time until retirement	12.7	3.5
Total	*22.2*	*4.8*
Employed: Not intenting to retire		
Working full-time	1.6	0.8
Working part-time	1.8	1.1
Total	*3.3*	*1.9*
Employed: Not sure if will retire		
Working full-time	4.7	0.6
Working part-time	1.6	1.0
Total	*6.3*	*1.6*
Actively looking for work (unemployed)	0.7	0.1
Not in labour force, intends to return to work		
Wants to work full-time	1.6	0.6
Wants to work part-time	2.2	1.1
Total	*3.8*	*1.7*

* *Source: ABS, Retirement and Retirement Intentions and ASFA.*

This suggests an increasing preference for part-time work over fulltime work as Australians move through the older age cohorts, and re-enforces the need for flexibility in policy settings regarding the interaction between work and access to superannuation.

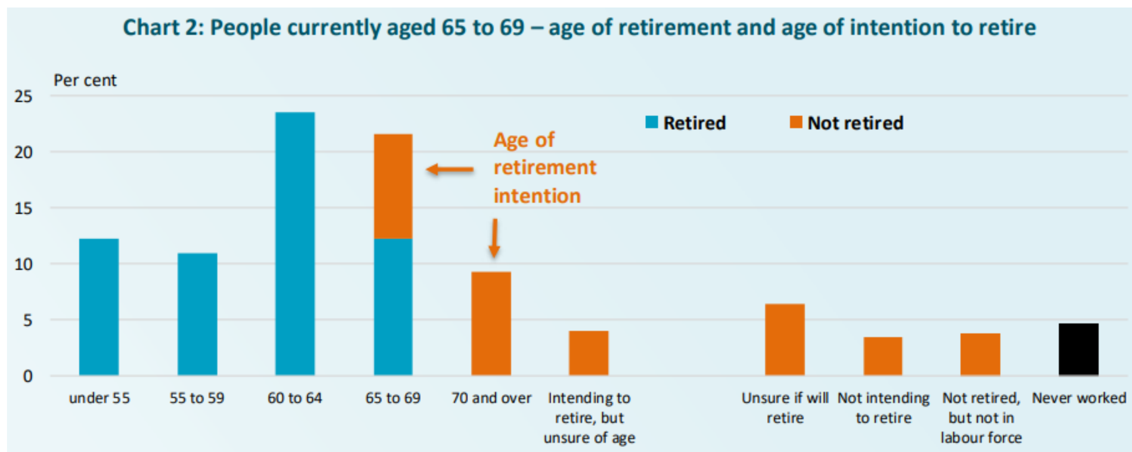
Looking ahead, Table 1 also reveals the varying intentions for future workforce engagement among older Australians. Within the 65 to 69 cohort who are currently employed (32% of the full cohort), around 70% have a specific intention to retire – though the expected timing of retirement differs (see next section).

Of the remainder, around 10% consider that they will not retire at all, while a further 20% are not sure if they will do so (similar proportions are reported for the 70+ cohort). For these two groups, financial considerations are likely to be the key driver of retirement decisions.

What age do people intend to retire?

Further insights around pathways to retirement can be gleaned from data on the age at which people (who are currently working or looking for work) intend to retire.

Chart 2 reflects the population of Australians currently aged 65 to 69 only.



- For people who are retired (blue bars), Chart 2 shows the age at which they retired from work.
- For people who are not retired (orange bars), Chart 2 shows the age at which they intend to retire.

59% of the 65 to 69 age cohort is retired (sum of the blue bars in Chart 2), with 23% having retired prior to the age of 60.

For those who are not retired (orange bars), retirement intentions are evenly split between those who:

- intend to retire when aged between 65 to 69 (9%)
- intend to retire when aged 70+ (9%).

A smaller proportion intend to retire, but are unsure of the age at which they will do so (4%). A substantial minority of those aged 65 to 69 do not intend to retire (3%), or are unsure if they will retire (6%).

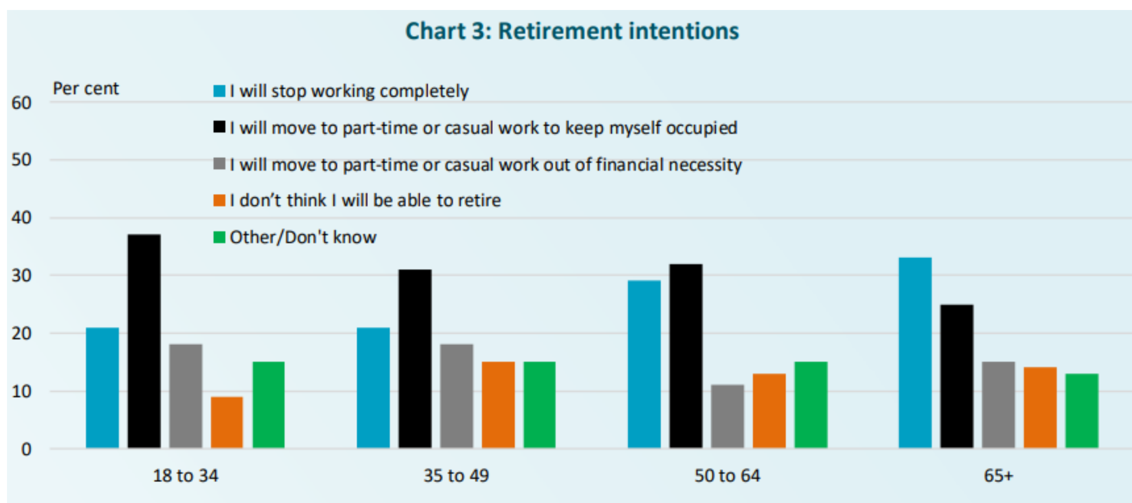
This highlights the differences in retirement pathways for older Australians, and the importance of retaining and improving flexibility in superannuation policy settings to support those differences.

It also highlights the fact that there is no typical pathway to retirement – for the majority of Australians it does not mean working full-time until the point of retirement between ages 60 to 67.

Drivers of retirement intentions

While retirement is not generally front-of-mind among younger Australians, it is instructive to assess and compare the retirement intentions of younger and older generations.

Derived from the ASFA survey, Chart 3 compares retirement intentions of the 65+ age cohort, with those of the three previous generations, where the results show the intentions of people who are not yet retired only.



Source: Redbridge survey for ASFA.

Note, this data is not directly comparable with the previous charts and tables as it excludes people who have already retired.

A striking feature of Chart 3 is the extent of the importance of staying employed in order to keep occupied – across all the age cohorts (black bars in Chart 3). While this result was highest for the 18 to 34 cohort (at almost 40% of respondents), 25% of the 65+ cohort reported this option as best representing their retirement intentions. Generally, these results may also reflect the importance of work as a means to remain active and/or maintain social connections.

The results for the 65+ age cohort (those who have yet to retire only), provide some context for the findings presented in the preceding sections. In particular, that a significant proportion of older Australians who delay retirement, and continue to work, do so for non-financial reasons.

Conversely, the survey results also confirm that some older Australians will need to continue to work for financial reasons. Indeed, 14% of the 65+ age cohort (those who have yet to retire only), don't think that they will be able to retire (orange bars). This is equivalent to around 3% of the total population of Australians aged 65+.

The Association of Superannuation Funds of Australia (ASFA) has been operating since 1962 and is the premier policy, research and advocacy body for Australia's superannuation industry.

US debt, the weak AUD and the role of super funds

John Abernethy

There is one significant observation that is neither well reported nor well understood. Readings of macro numbers sporadically report on it, but they do not delve into its significance or what it means for the flow of investment capital.

What is it?

It is the relentless strength of the USD, the mighty greenback. USD strength shows that the US economy is excessively calling upon and draining the developed world's capital.

The massive US fiscal, trade and capital account deficits are significantly (and disproportionately) funded by foreigners. The US economy dominates developed world growth, but it requires or feeds off continuous drawings of global capital.

This funding will continue for as long as the US corporate sector shows superior technological advancements over international peers.

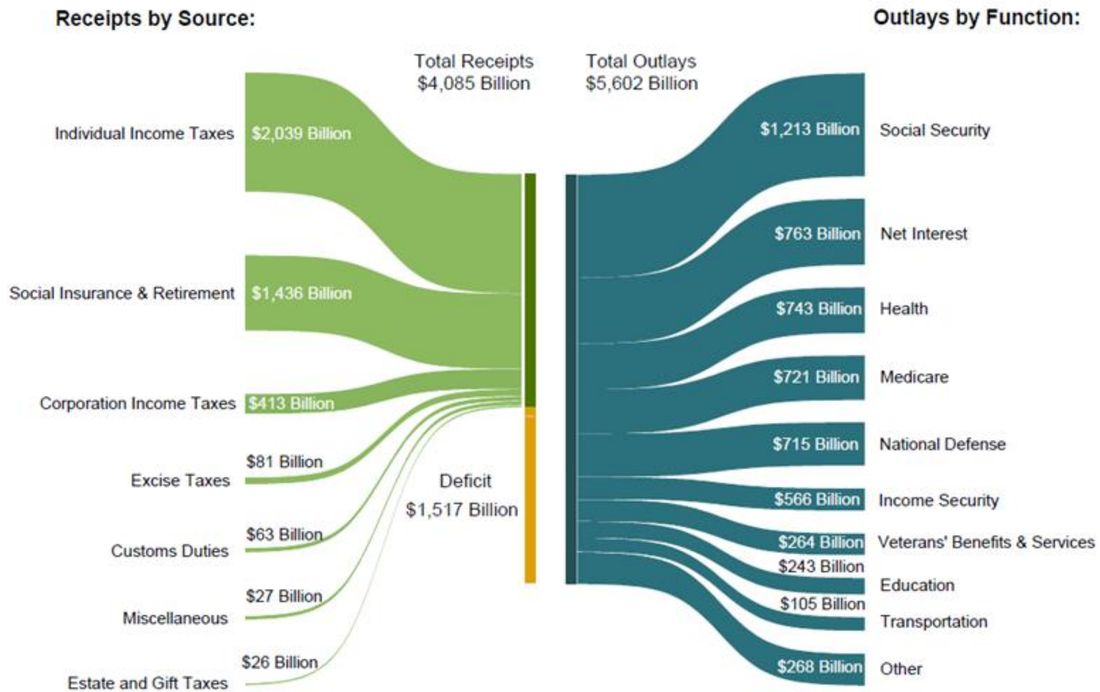
A moribund, ageing and over-regulated Europe provides little investment alternative to that of the US. And until Asian economies develop the ability to challenge the US in terms of liquidity and political, accounting and legal security, Australia will continue as a capital provider to the US.

The consequences are examined below.

US budget deficits and its debt are consuming the world's capital

Whilst the US economy approximates 30% of world GDP, its government now accounts for 32% of world government debt. Further, as its debt has grown it has burnt through foreign capital providers with Japan, China, UK and even Russia, each of which were large US bond holders at various points over the last 25 years.

The current budget (2024) is presented in the next chart and it shows a deficit of US$1.6 trillion. Inside that deficit, some US$763 billion is interest. This indicates that the US is currently paying (on average) about 2.1% for its debt.

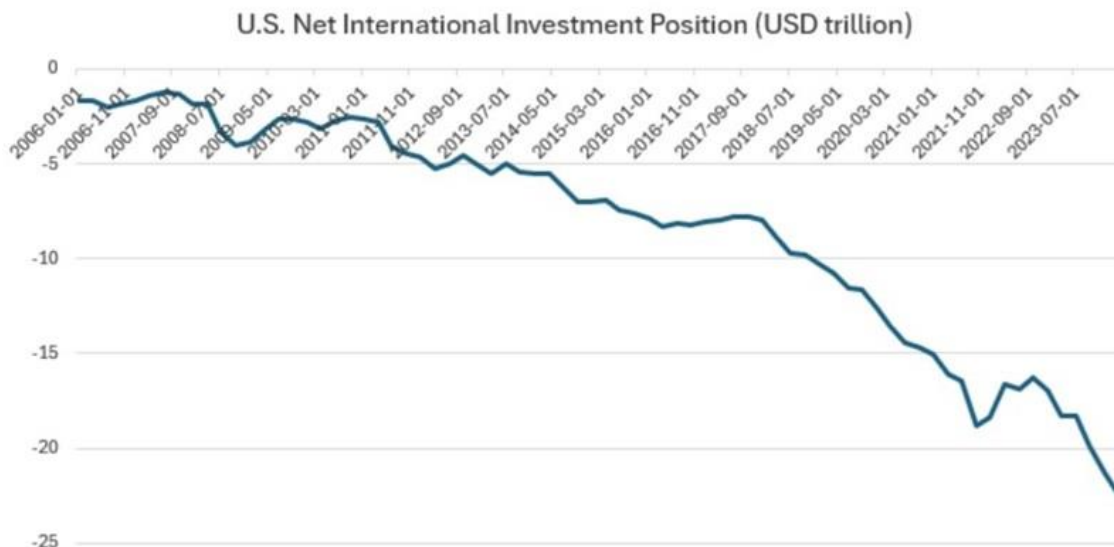


Source: US Treasury, Monthly Treasury Statement, July 2024

It is disturbing to note that if the US government was to pay its current cash rate (4.75%) for its debt, then the interest bill would rise to US$1.5 trillion. Simply stated, the US government cannot afford to pay current short-term interest rates and therefore the Fed needs to get interest rates down and quickly.

The US economy is dynamic, and it has propelled world growth prior to the entry of China, and now India, as alternative growth engines. The US stands well above the developed world in terms of both technological and medical developments, but it has drawn immense sums from its trading and investment partners to do so. It is stunning that 346 million citizens drive a world economy of 8.2 billion people.

The next chart is crucial: it tracks the net international investment position of the US over the last 20 years. This position measures the difference between US overseas owned assets and those held by foreigners in the US. It measures shares, bonds, corporate debt and property etc. and shows that the difference has grown from US$1.66 trillion (deficit) in 2005 to US$22.5 trillion (deficit) in March 2024. About 50% of this net capital deficit is held by foreigners in US bonds.

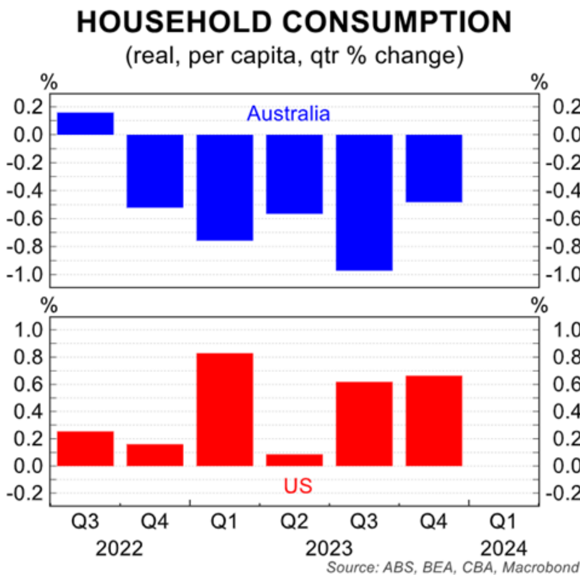


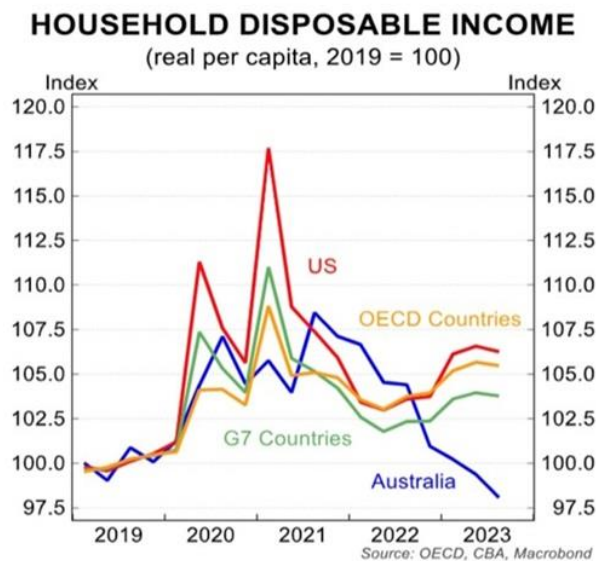
The transmission effect of these capital flows that fund US government debt is that the USD rises to meet the constant foreign currency inflows. It is a self-perpetuating positive loop for the USD. The more the US needs capital and funding, the higher its currency goes. So too do speculative assets that benefit from US pricing – gold and bitcoin are prime examples.

For Australia (in particular) and other developed economies, this has become a significant problem as the US draws our capital to sustain its growth. That growth is important for the world economy until the developed world takes over.

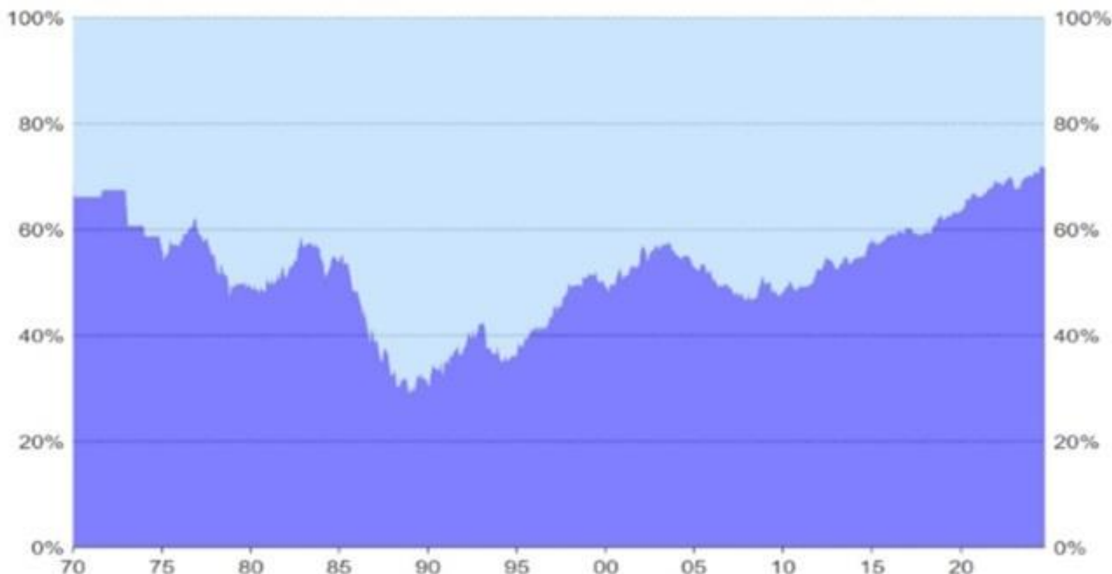
Indeed, this is shown clearly in the chart that compares Australia's real household consumption growth with that of the US household sector. US household consumption has driven both the US and the world economy.

US consumption growth is superior because it has achieved real disposable income growth. Australia's real disposable income has declined since the covid pandemic.





US consumption has also driven the profitability and therefore the valuations of US listed corporates compared to the rest of the world. Indeed, the US market now represents 72% of the world equity market index. That feature alone draws in massive quantities of index invested capital residing around the world in passive pension funds.



Weak AUD has consequences

So where does Australia sit in the complex funding of the US economy?

With A$3.7 trillion (US$2.5 trillion) of super assets, our superannuation funds are 30% larger than Australia's GDP. Our large industry funds have no choice but to invest in the US economy. Therefore, they will continue to contribute to the US economy by investing enormous sums into US Treasuries, corporate debt, equities, and infrastructure.

To do so, our super funds must sell AUD to buy USD. This means our currency will remain under selling pressure until the US economy falters or our capital managers can find other regions in which to invest.

Importantly, the international currency market will probably not revalue the AUD against the USD. Our credit rating, our trade surplus, our budget surplus, and our superior national debt position will have little effect on the value of the AUD. Therefore, our investment thought process must adopt as a likely scenario a weak currency outlook and its consequences.

Conclusions and observations

1. Australia's currency will continue to be undervalued which means that imported inflation remains a concern - cash rates will be held above our international peers;
2. Whilst the RBA will cut interest rates in 2025, it must be at a lower rate than those seen offshore – to support the AUD;
3. Mortgage rates will decline through 2025 giving relief to the "mortgaged" household sector – providing an uptick to Australian economic growth in 2025;
4. Australian inflation will meander downwards, and more cost-of-living support will be needed - expect significant pre-election packages.
5. Post the US election, the funding of the US economy will become a focus for bond markets in 2025 – any upheaval in bond markets will see a swift return to QE;
6. If QE returns as policy in the US, expect Europe to follow. The developed world has far too much debt and cannot support higher interest rates; and
7. Income returns (over capital growth) will dominate returns to investors – the outlier being the US equity market which continues to draw in passive capital.

My conclusions suggest a volatile outlook for markets in 2025 as the world once again is forced to assess the impacts from and policy responses required to deal with enormous debt levels.

Australia's debt problem resides in a part of our household sector. Our total household debt is too high, in a sector of the community which is the core of our future – the youth. The government needs to respond with smart assistance programs that do not further fuel house price rises. An intricate problem that is not being properly debated.

The world (particularly the US) debt problem resides in the government sector and it is most likely that the Fed will revisit its policy response adopted in the 2018 bond tantrum. Other central banks will then surely follow.

John Abernethy is Founder and Chairman of Clime Investment Management Limited, a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

For more articles and papers from Clime, click here.

America eats the world

James Gruber

Music historian and cultural critic, Ted Gioia, is one of my favourite current reads. He's on a mission to expose the degradation of aesthetics and design in modern things and his latest target is Tesla's Cybertruck.

He calls it "depressingly ugly" and "looks like it was designed by a third grader with a pen and ruler—who spent about three minutes drawing straight lines on the back of a homework assignment."

Harsh? You be the judge.

Alexander-93, CC BY-SA 4.0, via Wikimedia Commons

Gioia says that while straight lines dominate the Cybertruck, they didn't in the great cars of yesteryear, which mixed the straight with curves to create pleasing designs.

Source: Ted Giola

Gioia laments that it's a bigger problem than just the Cybertruck, with beauty lacking in everything from household appliances to sewer covers.

And he includes a quote from Antoni Gaudi, the visionary designer of the Sagrada Familia church in Barcelona:

"The straight line belongs to men, the curved one to God."

The art, then, is in the curves.

America eats the world

While a crude comparison, Gaudi's quote reminds me of investor Howard Marks' differentiation between first- and second-level thinking:

"First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in "The outlook for the company is favorable, meaning the stock will go up." Second-level thinking is deep, complex and convoluted."

Second-level thinking for investing is what curves are for design. It's looking beyond the obvious to the more nuanced and detailed solutions to a problem.

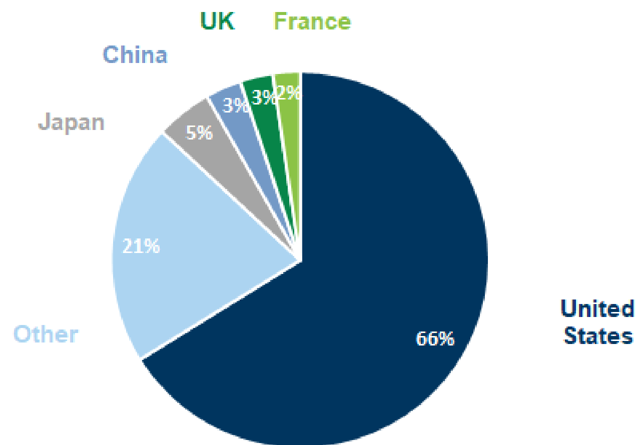
Firstlinks
a Morningstar company

This has relevance to today's markets. First-level thinking sees American dominance of global stock markets and believes that under Trump, that should continue.

After all, US markets are smashing through record highs and they're now an unprecedented 66% of the world equity index.

The chart is something to behold. The US is 13x larger than the next biggest weighting in Japan. It's worth noting also that technology is about 45% of the S&P 500, if you include stocks that aren't categorized as tech but mostly certainly are ie. Netflix, Amazon, Tesla and so on. That means US tech is about 30% of the world equity index. So, for anyone with an international stock ETF, congratulations, you are officially a concentrated investor.

MSCI AC World Index – country composition



Source: Goldman Sachs

It follows an extraordinary run for US stocks, not only this year but since the 2008 financial crisis.

CREATIVE PLANNING		Asset Class Total Returns Since 2011 (Data via YCharts as of 11/8/24)														@CharlieBilello	
ETF	Asset Class	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2011-24 Cumulative	2011-24 Annualized
N/A	Bitcoin ($BTC)	1473%	186%	5507%	-58%	35%	125%	1331%	-73%	95%	301%	66%	-65%	156%	81.1%	25519865%	146.0%
IWF	US Growth	2.3%	15.2%	33.1%	12.8%	5.5%	7.0%	30.0%	-1.7%	35.9%	38.3%	27.4%	-29.3%	42.6%	32.0%	713.4%	16.4%
GLD	Gold	9.6%	6.6%	-28.3%	-2.2%	-10.7%	8.0%	12.8%	-1.9%	17.9%	24.8%	-4.2%	-0.8%	12.7%	29.7%	78.7%	4.3%
SPY	US Large Caps	1.9%	16.0%	32.2%	13.5%	1.2%	12.0%	21.7%	-4.5%	31.2%	18.4%	28.7%	-18.2%	26.2%	27.0%	512.7%	14.0%
QQQ	US Nasdaq 100	3.4%	18.1%	36.6%	19.2%	9.5%	7.1%	32.7%	-0.1%	39.0%	48.6%	27.4%	-32.6%	54.9%	26.1%	969.9%	18.7%
IWD	US Value	0.1%	17.5%	32.1%	13.2%	-4.0%	17.3%	13.5%	-8.5%	26.1%	2.7%	25.0%	-7.7%	11.4%	19.9%	309.9%	10.7%
MDY	US Mid Caps	-2.1%	17.8%	33.1%	9.4%	-2.5%	20.5%	15.9%	-11.3%	25.8%	13.5%	24.5%	-13.3%	16.1%	19.7%	334.5%	11.2%
IWM	US Small Caps	-4.4%	16.7%	38.7%	5.0%	-4.5%	21.6%	14.6%	-11.1%	25.4%	20.0%	14.5%	-20.5%	16.8%	19.7%	268.5%	9.9%
PFF	Preferred Stocks	-2.0%	17.8%	-1.0%	14.1%	4.3%	1.3%	8.1%	-4.7%	15.9%	7.9%	7.2%	-18.2%	9.2%	12.4%	90.9%	4.8%
EEM	Emerging Market Stocks	-18.8%	19.1%	-3.7%	-3.9%	-16.2%	10.9%	37.3%	-15.3%	18.2%	17.0%	-3.6%	-20.6%	9.0%	11.8%	24.9%	1.6%
VNQ	US REITs	8.6%	17.6%	2.3%	30.4%	2.4%	8.6%	4.9%	-6.0%	28.9%	-4.7%	40.5%	-26.2%	11.8%	11.7%	197.3%	8.2%
CWB	Convertible Bonds	-7.7%	15.9%	20.5%	7.7%	-0.8%	10.6%	15.7%	-2.0%	22.4%	53.4%	2.2%	-20.8%	14.5%	10.9%	233.3%	9.1%
HYG	High Yield Bonds	6.8%	11.7%	5.8%	1.9%	-5.0%	13.4%	6.1%	-2.0%	14.1%	4.5%	3.8%	-11.0%	11.5%	8.5%	91.5%	4.8%
EMB	EM Bonds (USD)	7.7%	16.9%	-7.8%	6.1%	1.0%	9.3%	10.3%	-5.5%	15.5%	5.4%	-2.2%	-18.6%	10.6%	7.5%	63.0%	3.6%
EFA	EAFE Stocks	-12.2%	18.8%	21.4%	-6.2%	-1.0%	1.4%	25.1%	-13.8%	22.0%	7.6%	11.5%	-14.4%	18.4%	6.9%	103.8%	5.3%
BIL	US Cash	0.0%	0.0%	-0.1%	-0.1%	-0.1%	0.1%	0.7%	1.7%	2.2%	0.4%	-0.1%	1.4%	4.9%	4.5%	16.5%	1.1%
TIP	TIPS	13.3%	6.4%	-8.5%	3.6%	-1.8%	4.7%	2.9%	-1.4%	8.3%	10.8%	5.7%	-12.2%	3.8%	3.2%	42.3%	2.6%
LQD	Investment Grade Bonds	9.7%	10.6%	-2.0%	8.2%	-1.3%	6.2%	7.1%	-3.8%	17.4%	11.0%	-1.8%	-17.9%	9.4%	3.0%	64.3%	3.7%
BND	US Total Bond Market	7.7%	3.9%	-2.1%	5.8%	0.6%	2.5%	3.6%	-0.1%	8.8%	7.7%	-1.9%	-13.1%	5.7%	2.4%	33.6%	2.1%
DBC	Commodities	-2.6%	3.5%	-7.6%	-28.1%	-27.6%	18.6%	4.9%	-11.6%	11.8%	-7.8%	41.4%	19.3%	-6.2%	2.1%	-11.3%	-0.9%
TLT	Long Duration Treasuries	34.0%	2.6%	-13.4%	27.3%	-1.8%	1.2%	9.2%	-1.6%	14.1%	18.2%	-4.6%	-31.2%	2.8%	-3.3%	42.2%	2.6%
Highest Return		BTC	BTC	BTC	VNQ	BTC	BTC	BTC	BIL	BTC	BTC	BTC	DBC	BTC	BTC	BTC	BTC
Lowest Return		EEM	BIL	GLD	BTC	DBC	BIL	BIL	BTC	BIL	DBC	TLT	BTC	DBC	TLT	DBC	DBC
% of Asset Classes Positive		62%	95%	52%	71%	38%	100%	100%	5%	100%	90%	67%	10%	95%	95%	95%	95%

Undoubtedly, the US has incredible momentum and the latest ETF trading reflects that. Since Trump was elected, about US$12 billion has flowed into US ETFs each day, compared to the normal US$3-4 billion. This year, ETF inflows will smash records in the US, possibly reaching US$1 trillion.

In Australia, too, money has been pouring into international equity ETFs (which should really be renamed, mainly US equities with a splash of other countries). In October, A$3.2 billion flowed into ETFs, of which half went into international stocks.

VanEck ETF Industry Pulse October 2024

Overview

Total FUM for the industry to date	$233 billion
Monthly flows	$3.2 billion
Market cap change for the month	+2.7%
Market cap change for the last 12 months	+54.5%
Total number of ETFs in Australia	396
New ETFs listed	3
De-listed ETFs	1

Flows by asset class

Asset class	Net flows ($m)
Asset allocation	62.6
Australian equity	318.3
Australian fixed income	332.0
Cash	55.9
Commodity	205.7
Crypto	3.9
Currency	-0.6
Fixed income	17.1
International equity	1617.2
International fixed income	103.7
Leveraged and inverse	83.6

Source for all data: Bloomberg, ASX
*ASX data reports $225 billion. Official CBOE data not available yet but estimated to be $8 billion

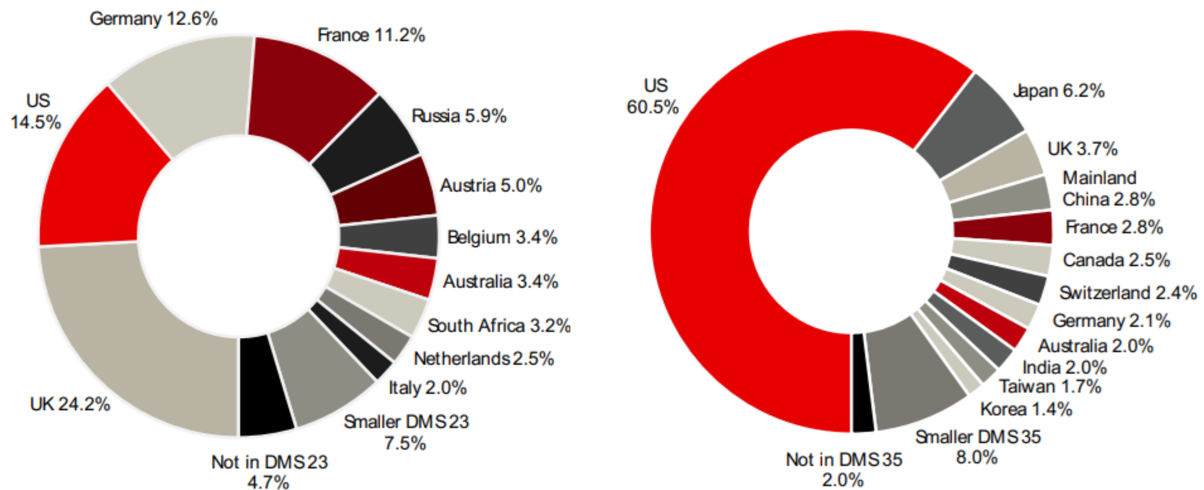
Source: VanEck

The question is whether the momentum in US stocks can continue. Since Trump's election, there have been a million and one articles on what it means for US markets and most are bullish on what comes next for stocks.

The odd bear has poked their head up and pointed to things such as the market concentration in US large cap tech stocks and how that concentration is unusual, thereby intimating that it can't continue indefinitely.

The bears also point to history showing one country's dominance of world equities doesn't last over the long term. Mean reversion seems inevitable, they believe.

Figure 2: Relative sizes of world stock markets, end-1899 (left) versus start-2024 (right)



Source: UBS Global Returns Handbook 2024

In my view, both the bull and bear narratives, while seemingly simple and compelling, suffer from the first-level thinking outlined by Howard Marks.

The feedback loop driving markets

Deeper questions remain. How have US markets gotten so large? How have the Magnificent Seven tech stocks (Nvidia, Apple, Microsoft, Amazon, Tesla, Meta, Alphabet) grown to US$17 trillion in market value, about 10x the size of the Australian economy? What's happened to the other countries which have lagged so badly?

Let's dig into the first two of those questions. Broadly, the US emerged as the world's sole superpower after World War Two when most other nations were on their knees. The growth from a relatively immature US economy into a more mature one has been impressive and enabled it to hold off emerging competitors through time, including Japan and China.

The rise of the Internet in the 1990s and Silicon Valley's central role in it, has turbocharged America's economy and markets. We've gone from barely any Internet users to 5.5 billion now, around 68% of the world's population.

It's fuelled the rise of mobile phones, software as a service, cloud computing, electronic gaming, virtual reality, and now, artificial intelligence (AI).

Stepping back, it isn't hard to see how this has happened. Sure, exponential increases in computing power have enabled the Internet's evolution. But it's the demand side that interests me.

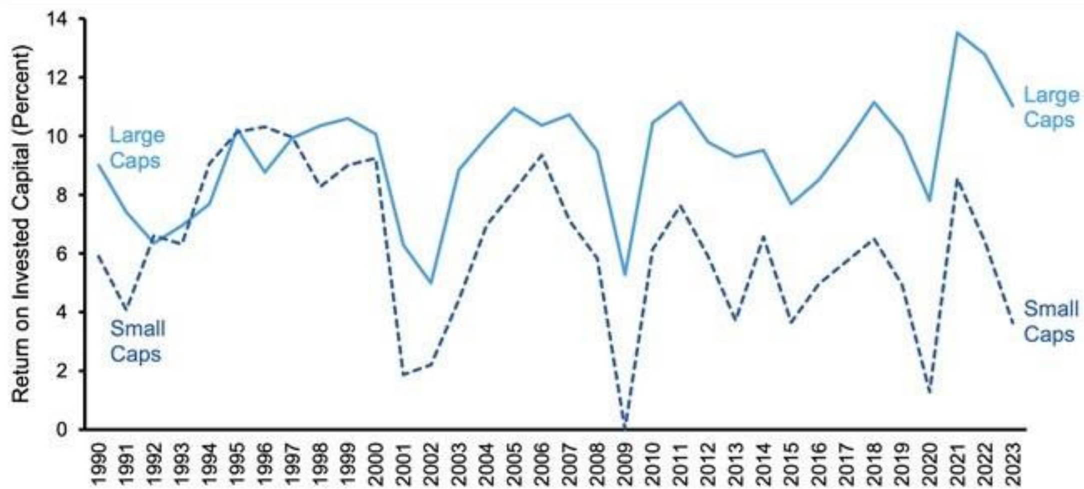
If we look at our own lives or those of our kids, most of it is spent online these days. For both work and play. We are locked into a tech orbit to such an extent that our worlds are predominately 'virtual' (on the net) rather than 'reality' (interreacting in the real world).

Our tech consumption is feeding the spending and data that powers the profits of the tech giants.

So while investors can question the valuations of the tech stocks, they can't question the extraordinary earnings that these companies are producing.

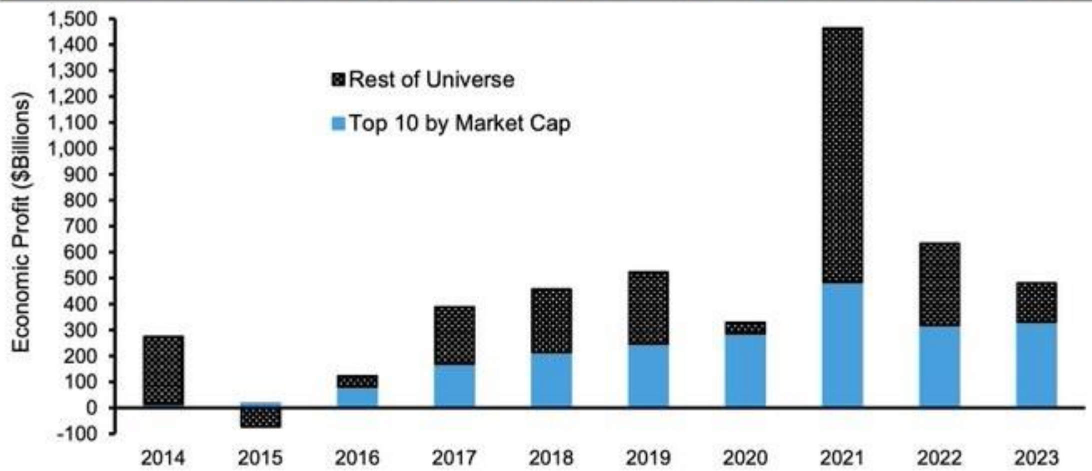
As strategist Michael Mauboussin points out, from 2014 to 2023, the top 10 stocks were 19% of the market capitalization of the S&P 500 on average while the companies made up 47% of the total economic profit (return on invested capital minus weighted average cost of capital). In 2023, the top 10 equities were 27% of the market capitalization and the firms contributed 69% to the total economic profit.

Exhibit 6: Aggregate ROIC for Large and Small Capitalization Stocks in the U.S., 1990-2023



Source: FactSet and Counterpoint Global.

Exhibit 5: Economic Profit of Top 10 by Market Cap and of Rest of Universe, U.S., 2014-2023



Source: FactSet and Counterpoint Global.

Our tech habits are driving the record net margins of tech giants, which are driving their record profits, which are driving increasing stock prices, which are driving more money into ETFs, which are driving rising market concentration in indices, which are driving share prices even higher.

It's a seemingly virtuous feedback loop.

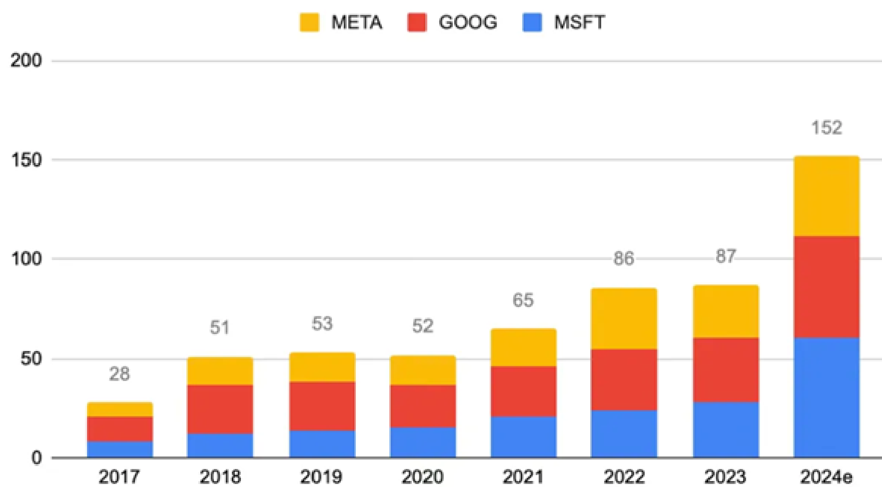
The capital light question

What could stop this virtuous loop? Perhaps it could be Trump and his policies, though it's hard to envisage him implementing things that will harm the US economy and stock market. Or maybe it could be extended stock valuations and the potential for a market correction. The issue is that if profits hold up, any correction may prove short-lived.

That gives a clue, though, for what could really hurt the US market and its tech stocks: pressure on earnings and returns on capital.

On this, fund manager John Huber has provided some great insights. He suggests that the massive ramp up in AI spending from the tech giants means that they're turning from capital light businesses into capital heavy ones.

This year, Microsoft, Alphabet and Meta are spending US$152 billion, more than 5x what they did just seven years ago.



Source: John Huber

On another metric, these three companies plus Amazon had capital invested (equity plus debt) of US$113 billion in 2017, and that's estimated to increase to US$724 billion this year.

Capital Invested	2017	2024
MSFT	18	138
GOOG	53	193
META	17	115
AMZN	25	278
Totals	**113**	**724**

Source: John Huber

It's easier to make good returns on smaller amounts of money than on larger ones. At US$724 billion in invested capital, Huber thinks returns are likely to prove much harder to come by.

That said, the returns have been still impressive to date.

ROIC	2017	2024
MSFT	139%	62%
GOOG	45%	42%
META	94%	40%
AMZN	12%	13%

Source: John Huber

Yet, the tech behemoths are forecast to plough even more money into AI in coming years. Even if capital expenditures remain at 2024 levels, that's US$750 billion over the next five years. AI will have to generate incredible returns to justify the spend.

Even still, the attractiveness of the tech companies has been their capital light models, and that's clearing changing going forward. In Huber's eyes, that could hurt returns and valuations, and I think he has a point.

This type of thinking looks beyond market noise to a more nuanced evaluation of the future. Looking less at the straight lines and more at the curves, as Ted Gioia might say.

James Gruber is editor of Firstlinks and Morningstar.

What's next for gold?

John Reade with James Gruber

This is an edited extract of an interview between John Reade, Senior Market Strategist for Europe and Asia at the World Gold Council, and Firstlinks' James Gruber, on October 29, 2024.

James Gruber: Gold is a hot topic - what's behind the rise in your view?

John Reade: I suppose it depends on the timeframe. If we take the last couple of years, I think that gold has put in a surprisingly strong performance despite a strong US dollar and higher US interest rates. And I think the reason for that unexpectedly strong performance has been connected to two things. First of all, there's been greatly increased central bank purchases, which doubled around 2022, and the second thing has been strong buying of all types, from emerging market sources, whether that's the central banks, whether it's Chinese retail investment, whether it's Chinese jewelry demand, whether it's Indian jewelry demand, whether it's investment demand out of Turkey and other countries too. The strength of emerging market demand, combined with a strong central bank demand, has really supported gold during times you'd have expected it to be under pressure.

And then turning to this year, we've seen leveraged investors, particularly on the COMEX futures market in the US, together with the beginnings of a return of Western investment demand over the last four or five months really add to the strength we've seen in gold.

Gruber: Central banks and emerging market demand, can we break that down - which central banks and which emerging markets are buying gold?

Reade: On the central bank side, we've seen buying every year since the GFC from central banks, and that's been predominantly emerging markets. The only developed market central bank that's bought gold in any quantity has been Singapore, but they've all generally been buying for the same reasons post GFC, and that's the fact that they've amassed lots of foreign currency reserves and didn't have much in the way of gold, and the GFC and other events have demonstrated to them that having gold in their portfolio made a lot of sense.

Gruber: With Chinese demand for gold, is that the outflow from money in property and stock markets to gold?

Reade: That's part of it. Pressure on the currency too has left a country where the savings rate is really high and fewer attractive alternatives to place those savings. So, gold's benefited there. It probably also benefited from the announcements from the People's Bank of China that they were adding gold to their reserves, almost sending a signal to the Chinese population that this was a good thing to buy. Almost state approved. So that may have been a contributing factor as well.

But, generally speaking, the emerging market buying we've seen has been for domestic, financial and political reasons. We've touched upon China.

In the case of Turkey, last year was a good example. High inflation, a manipulated currency ahead of the presidential election, Turkish citizens expecting the currency to fall sharply after the election was concluded, which indeed happened, led to buying up hard assets across the board - fridges, cars, dollars, and especially gold.

I think that's one of the reasons why the gold market was able to shrug off these traditional developed market drivers of the US dollar and interest rates, because the strength and enthusiasm of the buying of gold from emerging markets was so marked.

Gruber: The US dollar has been ripping higher and gold has still managed to perform well. How do you join those dots?

Reade: My view on it is fairly simple. The US economy is still a place where people want to put their money. Look at the returns that we've seen in asset markets in America.

I don't think that attitudes towards the economy will change much in the short term, irrespective, of who leads the country, but the prospects of a victor that can spend even more freely than is being spent at the moment probably runs the risk of higher inflation, probably runs the risk of tighter monetary policy. As a consequence, probably runs the risk of the US dollar staying in favor. And I think that may be what people are signaling at the moment.

Obviously there are differences in stated economic policy from the two candidates, but neither of them look as if they're about to get the deficit under control, and that's certainly one of the factors we're hearing from high net worth investors about why they're looking more towards gold than they have done perhaps in the last few years, is because of renewed concern about the outlook for debt and taxes.

Gruber: I'm always surprised about how little institutions here invest in gold. Have you ever seen a bit of a switch or is that yet to happen?

Reade: We've had some successes in the work that we've done trying to engage institutional investors on gold.

I've been down to Australia four or five times since COVID and have spoken at many conferences and engaged with many super funds, and I'd say that the pattern is very similar. In general, gold is still viewed by institutions here as an asset that's too far out of their recommended allocation.

Gruber: Gold miners haven't performed at the same level as physical gold, and that's been a trend ever since the GFC. Is it a hangover from that period, or are other factors at play?

Reade: I think there's some residual wariness towards the capital allocation decisions that were made during the last gold price boom, even though gold mining companies seem to and certainly say that they have changed the way that they're managing their operations.

But the other factor has been costs. Inflation is something that doesn't just affect consumers. It's been affecting gold mining companies too, and although there are signs that gold mine inflation, cost inflation, has fallen somewhat, it's a concern to investors.

The other thing as well is that emerging market investors and emerging market central banks have been the dominant force in [physical] gold in the last couple of years, but they're not necessarily natural buyers of gold shares. If Western investors return to gold, then perhaps gold equities will get renewed interest too.

Gruber: What are the keys for gold over the next 12 to 18 months?

Reade: Well, I hinted at it in the previous answer, which is that we need to see Western investors join the party. There are some signs that the emerging market buying we've seen over the last couple of years is slowing. For gold to continue to do well from here, we're going to need to see Western investors returning to gold.

James Gruber is editor of Firstlinks and Morningstar.

John Reade is a Market Strategist, Europe and Asia at World Gold Council, a sponsor of Firstlinks. This article is for general informational and educational purposes only and does not amount to direct or indirect investment advice or assistance. You should consult with your professional advisers regarding any such product or service, take into account your individual financial needs and circumstances and carefully consider the risks associated with any investment decision.

For more articles and papers from World Gold Council, please click here.

Consulting on the side? Don't fall into these tax traps

Peter Bembrick

A growing trend in recent years has been for experienced senior executives to develop what is known as a "patchwork career", where they take on a number of advisory roles – including non-executive directorships and consultancy work – as part of their transition to retirement.

This can be a very attractive option, allowing people to utilise their years of experience and knowledge but also provide more flexibility as they approach retirement than a more traditional full-time job. However, there are some traps to be aware of, particularly when it comes to tax, and specifically the Personal Services Income (PSI) tax rules.

These tax rules apply to anyone who is being paid primarily for their personal skills, as a way of ensuring they are taxed in a way similar to an employee. The cut-off is that if 50% or more of a person's income is generated

from personal efforts or skill (rather than from the sale of goods, use of assets, or from a business structure) then it will be counted as PSI and taxed accordingly.

The main intention behind the PSI rules is to prevent income splitting, or income being taxed at a lower rate (such as through a company) and also to prevent a consultant from claiming deductions that they would not otherwise have been able to claim as an employee.

For example, anyone receiving the majority of their income as a consultant based on their personal expertise is likely to be taxed at the marginal tax rate under PSI rules. It also applies to a contractor based on services, or a professional practitioner in a sole practice.

There are a number of tests to help people work out whether they fall within the PSI rules. Two of the most common are the results test and the unrelated clients test. If either of these tests can be satisfied, then people may be able to argue that the PSI rules don't apply to them.

Results test

The results test has three key criteria, all of which must be met. They are: the consultant is being paid by a client to produce a specific result; they provide their own tools and equipment (where relevant); and are liable for rectifying any defects arising from their work. If all three rules can be satisfied, then the PSI rules don't apply.

For example, if a consultant is paid based on the number of hours worked, rather than achieving specific deliverables or meeting certain performance targets, then they will be liable under the PSI rules.

Common situations where the results test might apply include where someone is contracted to oversee a specific project such as a marketing campaign to increases sales, or the successful sale of a business. Having specific outcomes that determine the consulting fees or receiving a success fee make the applicability of this test more likely.

Unrelated clients test

A consultant will often have multiple clients that are unrelated to each other. As long as no more than 80% of their personal services income for a year is received from a single client, the PSI test may not apply.

However, a critical part of this test is that not only is the consultant offering their services to the public at large, but that consulting engagements are received from offers to the public or a section of the public.

The most common sources of work for many consultants are referrals from their existing contacts, word of mouth referrals or their strong personal reputation. The ATO's view as summarised in Taxation Ruling TR 2022/3 is that this is not sufficient to meet the unrelated clients test and the PSI tests may be failed, meaning, for example, that consulting income received through a company may be attributed under the PSI rules to the individual consultant, and some company deductions may be denied.

A common approach is for people to use the fact that they have a website and a LinkedIn profile, and that they undertake promotional activities such as speaking at conferences and publishing articles in industry journals. However unless they can show that there is a direct connection between this promotion to the public and receiving the consulting engagements, it is not enough to pass the test.

In order to satisfy the unrelated client test, it is necessary to show that at least some of the consulting work was obtained from sources such as the website or LinkedIn enquiries, conference attendees or readers of published articles, or from direct advertising, sponsorship or other marketing activities, rather than simply from word of mouth or contact referrals.

It is important for consultants to be aware of the risks of the PSI rules applying, especially where they want to split their income or work through a company. The risks will be reduced if they can clearly show that they have contracted to achieve a result, as none of the other PSI tests will have to be applied.

Failing that, if consultants seek to rely on the unrelated clients test it is critical that they take steps to show that they are offering their services to the public and that they are able to show that at least some of their consulting engagements were received directly through their own promotional activities.

Recent ATO guidance

To make matters even more complicated, on 28 August 2024 the ATO released a "practical compliance guideline" (PCG) on the PSI rules. While still in draft, the PCG makes it clear that the ATO is looking closely at anyone who claims exemption from the PSI tax regime.

If it believes people are using the exemptions to unfairly reduce their tax, the guidance explains that the ATO can still apply the Part IVA anti-avoidance rules. The PCG also outlines the type of arrangements the ATO considers to be high and low risk, although this is still highly subjective which makes it extremely hard for people to have certainty that their arrangements will be accepted by the ATO.

It is therefore more important than ever for people to ensure they are acting in good faith when it comes to their personal tax arrangements and to seek appropriate tax advice.

Peter Bembrick is a Tax Partner at HLB Mann Judd, Sydney. This article is for general information only. It should not be accepted as authoritative advice and any person wishing to act upon the material should obtain properly considered advice which will take into account their own specific circumstances.

Disclaimer

This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.

Any general advice has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) without reference to your financial objectives, situation or needs. For more information refer to our Financial Services Guide at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Past performance does not necessarily indicate a financial product's future performance.

For complete details of this Disclaimer, see www.firstlinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.