Stewart Brown Advisory Pty Ltd

March 2019

INVESTMENT UPDATE

Given the upcoming federal election and the likelihood of the Australian Labor Party (ALP) winning the election, we wanted to bring you this update on the proposed changes we believe will impact clients and how we are positioning client portfolios to get ready for this change.

The Election

The ALP's proposed taxation reforms are substantial. Below we have detailed only the proposals we believe will impact our clients and the ones we have been focusing on to try and mitigate the potential damage to our client's income and capital. The key proposals and implications are:

Super Funds

- Non-concessional contributions (after tax contributions) to super will be reduced from $100,000 to $75,000 p.a.
- The income threshold for the extra 15% contributions tax for high income earners to be lowered to $200,000 from $250,000 p.a. (Division 293 tax)
- Catch-up concessional contributions will be abolished
- The tax deductibility for personal superannuation contributions will be removed
- SMSF borrowing will be eliminated
- Superannuation Guarantee to be expanded to include parental leave and salaries of less than $450 per month
- The superannuation guarantee rate to increase to 12% ahead of the current timetable "when prudent"

Negative Gearing

The ALP proposes to limit negative gearing against salary and wage income to new housing development from a yet-to-be determined date after the election.

All investments made before this date will not be affected by this change and will be fully grandfathered.

Losses from new investments in shares and existing properties can still be used to offset investment income tax liabilities. These losses can also continue to be carried forward to offset the final capital gain on the investment.

Capital Gains Tax

The ALP will halve the capital gains tax discount for all assets purchased after a yet-to-be determined date after the election. This will reduce the capital gains tax discount for assets that are held for longer than 12 months from the current 50 per cent to 25 per cent.

Investments made before this date will not be affected by this change and will be fully grandfathered.

This policy change will not affect investments made by superannuation funds. The CGT discount will not change for small business assets.

Trusts

The ALP has proposed to introduce a standard minimum 30 per cent tax rate for discretionary trust distributions to people over 18 years, commencing 1 July 2019. Currently distributions are taxed in the hands of beneficiaries at their marginal income tax rates.

Individuals and businesses can continue to make use of trusts, and trusts will not be taxed liked companies, as the beneficiaries will be taxed.

ALP's policy will also not apply to farm trusts and charitable trusts.

Franking Credit Rebates

This is by far the most discussed and highly controversial of the ALP's proposals. The 'accounting' side of this can be quite tricky to understand due to the terminology used, but we will try to explain it in simpler terms.

In finance-speak, this change would see;

"Imputation credits for individuals and superannuation funds no longer being a refundable tax offset.**"**

This means that franking credits can still be used to reduce tax payments, but the excess credits cannot be used for cash refunds.

This essentially only impacts entities and individuals whose franking credits are greater than the income tax they pay but is a major change nonetheless, as these refunds can be vital to the financial security of retirees.

The policy will apply from 1 July 2019.

The ALP will also introduce a 'Pensioner Guarantee' meaning Centrelink pensioners and allowance recipients will be protected from the abolition of cash refunds for excess dividend imputation credits. Self-managed superannuation funds with at least one pensioner or allowance recipient before 28 March 2018 will also be exempt from the changes.

Strategies to help mitigate the impact

Strategies vary between clients due to the size of the portfolio or fund, age of the investors, whether funds are in accumulation phase or pension phase, unrealised capital gains and estate planning reasons, to name a few. Some of the strategies we have been working on are detailed below but please remember each portfolio is unique and not all strategies will be applicable to your portfolio or fund. Stewart Brown Advisory delivers a personalised service, so we are looking at what is right for your circumstance.

- Increasing income through investment in corporate credit funds such as Metric Credit Partners funds, Perpetual Credit Income Fund. These funds aim to pay a cash yield of 4.75% to 7% (3.25% to 5.5% net of fees above the cash rate, which is currently 1.5% p.a.). Both PCI and MOT are listing on the ASX in the next few weeks.
- Switching to hybrids which are not fully franked. For example, the new Macquarie Group Capital Notes 4 are expected to be franked at 45% and offer a franked yield of 6.05% or 5.07% excluding franking.
- Tilting our Australian equities investments towards high yielding stocks which are only partially franked or not franked at all. These include: CSL, Resmed, Pendal, Brambles, Sydney Airports.

- Continuing to participate in attractive corporate actions as companies with large franking balances look to pass franking credits to shareholders via special dividends and off-market buy backs. Such as the BHP & RIO buy backs in late 2018.
- Ensuring funds are at strategic weights in Australian Real Estate Investment Trusts (A-REITs) which do not pay franking credits. These Include: Goodman, Dexus, Lendlease, Charter Hall, Vanguard Australian Property Index fund and VanEck Vector Australian Property Fund.
- For those funds in accumulation phase, re-setting cost bases on investments with a capital gain and thus utilising franking credits to offset capital gains tax.
- Looking for offshore investments with an income stream and capital growth such as the Pengana Private Equity Fund.
- Harvesting dividends as the current 45 day holding rule required for franking credit offsets, will be irrelevant if franking credit offsets are not needed.
- Rolling from pension phase into accumulation phase to utilise franking credits and reduce overall tax rates.
- Adding children to your SMSF who are paying contributions tax on concessional contributions and earnings tax in accumulation phase. This may give them the ability to utilise your franking credits which would otherwise be lost.
- Looking to pay franked dividends from private companies where you expect a tax refund of the franking credit, before 30 June 2019.

Portfolio Review

- Following the December quarter, markets bounced strongly during January and February. The primary driver of the reversal in sentiment was a signal by the US Federal Reserve that it would be patient in raising rates, given recent market volatility. China also responded to weak economic data with a boost to liquidity. This reminds investors that sagging economic data is often secondary to the effect of artificial liquidity provided by central banks.
- In February most ASX listed companies reported their half yearly results. Overall it was a relatively poor reporting season with many companies reporting reduced profits growth and the consensus outlook is for softer conditions ahead.
- The Australian banking sector has rebounded strongly since the Hayne Royal Commission delivered their final report. ANZ Banking Group, Stewart Brown Advisory's preferred banking stock, has risen from $22.98 on 21 December to around $27.00, a rise of over 17%. The average dividend yield of the four major banks is currently of 6.65% p.a. or 9.50% p.a. including the franking credit.
- We believe the tightening of bank lending practices is the principal cause of Australian residential property market weakness. There is little doubt that a slowing housing market is having knock-on effects in some areas of the economy, particularly household spending. At their March meeting, the Reserve Bank kept cash rates unchanged at 1.5%. Policymakers said that the decision is consistent with sustainable growth in the economy which is expected to be around 3% in 2019. The Australian labour market remains strong with the unemployment rate at 5%. With bank shares a core holding in client portfolios this is one area which demands continued scrutiny.

Forecasted returns

Each quarter we review the 10-year forecasted returns of each of the major asset classes. We use 10-year forecasts as they are more accurate than short term forecasts and of course, you are investing for the long term. The life expectancy of an 80 year old is 10+ years.

We use the forecasted returns to:

- Determine which markets are cheap, fair value, fully priced or overpriced. We compare the expected return of each of these markets with term deposit (TD) rates which is the return you can achieve risk free.
- Calculate our target investment allocation weight in each asset class. The more expensive the investments are, the lower the future expected returns are; the less we pay, the better future expected returns are. We make changes to portfolios very slowly over 18 to 24 months as a result of these valuation changes. Timing the exact turning points in markets is impossible. This process helps portfolios benefit from as much upside as possible as prices get more expensive. Conversely it allows portfolios to gradually buy cheaper assets as prices decrease.
- Track whether your financial goals are likely to be achieved.

The table below reflects our current view on the relative attractiveness of each market.

The rapid bounce in prices during Jan and Feb have put most asset classes in fair value territory. Additionally, term deposit rates have fallen during the quarter.

Asset Class	Index & current Level	Current Status	March 2019 Forecasted return p.a.	Dec 2018 Forecasted Return p.a.
Cash	at call 1.80%		2.3%	2.3%
Term Deposit	1 yr TD rate 2.75%		3.0%	3.3%
Australian Equities	All Ords - 5821	Fair Value	7.7%	8.7%
US Equities	S&P500 - 2790	Overpriced	2.9%	
World (exc. US) Equities	FTSE All World DM - 255	Cheap	9.8%	
Emerging Market Equities	FTSE EM - 663.8	Fair Value	6.3%	6.8%
A-REITs	ASX REIT - 1400	Fair Value	6.9%	8.2%

Cheap	Forecast 5% pa or more above Term Deposits (TDs)
Fair Value	Forecast 2.5% to 5% pa above TDs
Fully Priced	Forecast 0% to 2.50% pa above TDs
Overpriced	Forecast return lower than TDs

If you would like to discuss any of the information presented here, please do not hesitate to contact the office on (02) 9412 3033.