FLOAT WATCH

Break-up reality for realty part

Domain Holdings Australia Pty Ltd

ASX CODE: DHA
SEPARATION: One for every 10 Fairfax Media shares
LISTING PRICE: TBC
MARKET CAP: TBC
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Is it time to split up? Break-ups are never easy but sometimes it's the right thing to do.

In the corporate world everyone talks about mergers and acquisitions. There is a hype around them, although many integrations are a balancing act.

Corporate break-ups are less popular in finance.

The board of Fairfax Media believes it is in the best interest of shareholders to separate the fast-growing Domain business from the Fairfax Media business. Domain is a real estate-focused media company and owner of one of Australia's largest real estate listing portals, Domain.com.au. Fairfax will remain the largest shareholder with a 60 per cent controlling interest in the newly listed ASX company. The idea is to attract a "fair" valuation for the stand-alone Domain entity, which it might otherwise not achieve within the struggling Fairfax business. Simultaneously, Fairfax hopes to generate superior returns through its 60 per cent interest in Domain.

However, advantages of the separation may not materialise and having two listed ASX companies results in higher overheads and one-off transaction costs of $14 million.

Separation comes at a price and while this may be traumatic in this case it appears the two businesses are fundamentally different and a break-up is needed to unlock value.

SIMON HERRMANN

Beware professional pitfalls

As an SMSF trustee, it pays to check professional advice

MONICA RULE

SMSF operators who may be under the impression their fund can loan them money for other investment use need to read this carefully. There are a significant number of professionals giving out some seriously wrong advice on related party lending.

Some professionals believe that a self managed superannuation fund (SMSF) can lend up to 5 per cent of the value of its assets to fund members or the members' relatives. Loans to members or their relatives are prohibited by the superannuation law and you can get into trouble with the Australian Taxation Office for going down this path.

So why are professionals getting this wrong? The reason they are misinterpreting the law is because the superannuation law does allow lending of up to 5 per cent to a "related party" of an SMSF. The law is referred to as "in-house asset" and is covered by section 71 of the superannuation law. Section 71 appears under part 8 of the superannuation law.

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

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

What members of SMSF and professionals do not realise is that if they read on to subsection 65(7) of the superannuation law, they will see that it states, "Nothing in Part 8 limits the operation of this section". And there's the nub of this vexed issue: Essentially this means that section 65 overrides section 71 which is in Part 8 of the superannuation law.

This means that SMSFs can never lend to their members or members' relatives, not even the 5 per cent in-house asset limit, regardless of what is allowed under section 71.

Of course if a professional is unaware of subsection 65(7), they could easily conclude that as a related party, members could borrow money from their SMSF.

Now you may want to know whether an SMSF can lend to a related party who is not a member or a relative of a member of an SMSF. The good news is it can. An SMSF can lend up to 5 per cent of the total value of its assets to a related entity such as a related company or a related unit trust.

> If you get advice that seems too good to be true, get a second opinion

It can also lend an unlimited amount to a member's cousin or their former spouse (who are not members of their SMSF) because they are not considered related parties.

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

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

So if your cousin or your former spouse is not a member of your SMSF, then you can lend to them. But if they are members of your SMSF, then your SMSF cannot lend to them, not even the 5 per cent in-house asset limit.

The superannuation law can be complex as it has various twists. The fact that professionals can get it wrong confirms to me just how complex it can be.

If you get advice that seems too good to be true, get a second opinion. Having a working knowledge of the law can be immensely helpful in spotting advice that is not up to the mark.

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

Big changes afoot for residents in aged-care

JOHN RAWLING

The government has a major issue with aged care — to put it simply. It has not yet worked out how to convert the increased wealth of aged-care residents (created by higher property values) into a greater contribution to the cost of their care.

But one thing is for sure — costs are going to rise in the system, and these cost increases could be dramatic.

Government expenditure on aged care reached $17.8 billion in 2016-17, up from $14.7bn in 2013-14. Budget papers confirm this increase of more than $1bn a year is expected to continue for the foreseeable future. And things are not expected to drop off — predictions are that the over-65 population in Australia will increase from 3.5 million today to 9 million by 2054.

The government recently received the 196-page *Legislated Review of Aged Care*, written by retired senior public servant David Tune, who was asked to look at the impact and effectiveness of changes introduced in 2013 and make recommendations for future reform. Tune's report is the fifth relating to aged care the government has received this year. In addition to warning that $33bn must be invested in residential aged care in the next decade, the review made 38 recommendations. Included in the list are recommended changes to home care, residential care and the tricky issue of fees.

Two of the key recommendations were immediately knocked on the head for being too politically sensitive. The first of these was the recommendation that the cap of $162,815 on the value of the family home be removed when calculating the means-tested fee. The second was that both the lifetime and annual caps (currently $63,759.75 and $26,566.54 respectively) for the means-tested fee be lifted.

The means-tested fee is the government's method of getting residents with financial capacity to contribute more to the cost of their care and reduce the government's share of the funding. This fee, based upon the income and assets of the aged-care resident, can range from nothing for residents with little or no means up to a maximum of $245 per day for residents who have substantial means.

To put this into perspective, under the current funding model an aged-care provider may be entitled to nearly $90,000 per year for a high-care resident, of which the resident can be asked to contribute up to the annual cap of $26,566.54. This amount represents just over 100 days' worth of cost.

The treatment of the family home in the calculation of the means-tested fee is also politically sensitive. When this fee was introduced in July 2014, a home in Melbourne worth $500,000 was included as an assessable asset valued at $154,179.

Since then, the cap has been indexed upwards and currently sits at a maximum of $162,815 — an increase of 5.6 per cent or $8636, with no increase in fees paid by the aged-care resident. Using average median property price increases over the same period, this home has increased in value to nearly $700,000 — an increase of $200,000, or nearly 40 per cent. As I said earlier the government has not yet discovered how to convert the increased wealth of aged-care residents into a greater contribution to the cost of their care. But the problems with aged-care funding won't be going away anytime soon.

Aged-care residents should prepare for some dramatic changes. The trend for increasing fees is already there. In July 2014 the income-tested fee — which was based on income only — was replaced by the means-tested fee, based on residents' assets and income.

The government will surely be looking closely at other options to spread the aged-care funding burden.

John Rawling is an aged-care consultant at Joseph Palmer & Sons

Active-passive framework sets up chance of Goldilocks-style just right call at just right time

TONY KAYE

Renowned US investment consultant Charles D. Ellis wasn't mincing his words back in 1975 when he drew attention to the fact most active fund managers don't deliver on their promise.

"Contrary to their oft-articulated goal of outperforming the market averages, investment managers are not beating the market. The market is beating them," Ellis said in his article "The Loser's Game".

More than 40 years after Ellis first penned his controversial article, in which he also advocated a strategy based on diversified low-cost index fund investing, the spotlight on active investment management returns is burning brighter than ever. Craig Lazzara, New York-based Global Head of Index Investment Strategy for S&P Dow Jones Indices, says professional investment management has become "a zero-sum game", because the only source of outperformance for the winners is the underperformance of the losers.

The latest S&P Indices Versus Active Scorecard report (SPIVA) published by S&P Global shows 61.69 per cent of Australian equity general funds underperformed against the S&P/ASX 200 index in the year to June 30.

The story isn't any better over the longer term, either. Over three years, 65.69 per cent of active managers underperformed the key Australian benchmark index; over five years, 64.69 per cent missed the mark, and even over 10 years — representing the full phase of stock market activity since the global financial crisis — 75 per cent underperformed.

"Not surprisingly, as investors have been disappointed by the performance of active managers, they've looked for alternatives," Lazzara said during a visit to Australia just recently. "And of course, as it happens, passive management has been able to deliver competitive returns, low fees, transparency and, depending on the structure, perhaps tax efficiencies."

Active-passive

But should investors bother with active management strategies at all? As Wealth columnist James Gerrard argued last weekend ... investors should be covering both bases, because there's a definite place for both active and passive holdings. It all comes down to good asset allocation and discipline.

Vanguard Australia Head of Investment Strategy, Aidan Geysen, says investors deciding how to allocate their portfolios across actively managed and index investments should follow clear processes to avoid arbitrary decision-making.

"Discussions about active and index investing can draw some strong views from investors and their professional advisers, one way or the other," he says.

"The best method for achieving a reasonable allocation is derived from a core philosophy of having clear goals, minimising costs, being diversified and maintaining discipline. We see active-passive not as a debate, but as an asset allocation decision, and this framework gives investors a clear process to help them determine the active and index allocations within their portfolio."

A much discussed "decision-making framework", developed by Vanguard's global Investment Strategy Group, targets four variables to help investors consider when deciding how to implement index, active, or a combination of both, for a given asset class in their portfolio: gross alpha expectation, cost of active management, active risk, and risk tolerance.

"Investors will invariably have different goals, return requirements, time horizons and risk tolerance, and so whether or not a higher allocation to active is appropriate can differ greatly," Geysen says.

"In some cases, a higher allocation to active may be appropriate when expected alpha outweighs management costs, when an investor is comfortable with the level of risk being taken, and when the investor has the discipline to stick with an active strategy through periods of underperformance.

"But an investor can still choose to balance that active risk with an index component in their asset class exposure, accounting for potential underperformance. In the end, choosing between active and index isn't a philosophical decision — it's part of the asset allocation process," he explains.

EFT drivers

Meanwhile, Lazzara says the huge inflows of retail investor capital into passive exchange-traded index funds is a direct reflection of the disappointing performance of active managers. He says the growing sophistication of retail investors and ETF products, including the rise of factor-based "smart beta" funds that use stock screening criteria to mimic the strategies of active managers, is making it increasingly harder for active fund managers to outperform.

Another factor he highlights is the low level of low dispersion in the stock market between the best and worst-performing stocks. Dispersion is a measure of the breadth of performance in the market. A good active manager will benefit in a high dispersion environment because it is relatively easier to pick stocks that will outperform. If the better stocks are outperforming the worst stocks by a large margin, the manager's overall fixed costs will be easily covered.

"One of the things that has made active management particularly difficult over the past six to eight years is that dispersion has been quite low," Lazzara says. "An active manager's skill level does not depend on dispersion. But the value of skill is higher when dispersion is higher."

Vanguard's Geysen says a decision-making framework can help investors work out whether an active or index strategy is right for their circumstances.

"But patience is the key," he says. "For those Australian managed funds that outperformed over the past 15 years, 97 per cent still experienced three or more individual years of underperformance, with 60 per cent experiencing six or more. A framework like this might not always deliver investors the 'just right' Goldilocks combination of index and active, but it can help keep their investment goals at the forefront of their decision-making, ensuring that they choose the right funds or investment strategies for the right reasons."

Tony Kaye is the editor of Eureka Report, which is owned by financial services group InvestSMART.

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