3 yield opportunities in small and mid-cap land

by Tony Featherstone

Key points

- *There are interesting yield opportunities in small- and mid-cap land for experienced investors, who are willing to take slightly higher risks for higher returns.*
- *Wilson Asset Management's WAM Capital LIC has consistently outperformed its benchmark S&P/ASX All Ordinaries Accumulation Index and grown dividends each year since the 2008 GFC.*
- *The Russell High Dividend Australian Shares ETF and the Contango MicroCap LIC also offer strong yields.*

These are crazy markets. The great global experiment of quantitative easing and secular stagnation in developed markets (weak demand and overcapacity) has distorted interest rates, and an ageing population has increased demand for higher-yielding securities.

That is not to say markets cannot rally. I believe markets are in the second stage of a bull market, characterised by slowly improving earnings. We are still a long way from the third stage of excess, where taxi drivers want share tips and friends quit their jobs to day-trade.

But it is getting tough for income investors to put new money to work and find sufficient, reliable yield to live on. They must accept lower income returns and higher risk as valuations rise and the capacity of large companies to lift or even maintain dividends is stretched.

How should self managed superannuation fund (SMSF) trustees, who prefer to invest directly and through listed rather unlisted products, respond? One strategy is looking further down the market for yield to small- and mid-cap industrial stocks. Or using listed managed funds, such as listed investment companies and exchange-traded products, to bolster diversification.

Many small- and mid-cap stocks seemingly offer attractive income. But their high dividends are sometimes an illusion, based on a falling share price that inflates the yield. The weak share price signals that the company has earnings problems and less capacity to maintain a dividend or even pay one. Rookie investors overlook the critical factor: dividend sustainability and growth in dividends per share.

Nevertheless, there are interesting yield opportunities in small- and mid-cap land for experienced investors who are willing to take slightly higher risks for higher returns. The key is minimising that risk through diversification or by buying quality, slightly undervalued stocks.

The ideas below show it is possible to achieve higher grossed-up yield than with the banks, Telstra and other prominent income stocks, through a listed-fund approach that lowers risks. Yes, the total shareholder return (including capital growth) might not be as good if CBA and Telstra continue their rally, but the ideas stack up for those mostly seeking income, without the risk of buying individual stocks at inflated valuations.

Here are three ideas to consider:

1. WAM Capital

Rising demand for yield and low-cost investment has underpinned a resurgence in the Listed Investment Company (LIC) sector in the past 18 months. Once described as the "dogs of the ASX", LICs are growing rapidly as more fund managers launch LIC

Initial Public Offerings, and established LICs raise capital and cater to yield-hungry SMSF trustees.

Wilson Asset Management's WAM Capital is a good example. It lifted the fully franked interim dividend for the first half of 2014-15 by 7.7% to 7 cents. At $1.93, that equates to an annualised dividend yield of about 7%, or 10% after full franking.

WAM has consistently outperformed its benchmark S&P/ASX All Ordinaries Accumulation Index and grown dividends each year since the 2008 GFC. As a LIC, it manages a portfolio of stocks, giving investors high yield with better diversification than with owning a single stock.

WAM is trading at a 3% premium to its latest stated pre-tax Net Tangible Assets (NTA) of $1.88, after share-price falls in the last few weeks. It traded at a 16% premium to pre-tax NTA at the end of February, ASX data shows, and has consistently traded at a premium given the long-term outperformance of its underlying investment performance.

The premium compression after share price falls in recent weeks might be an opportunity to buy WAM Capital. It is still trading at more than its assets are worth, but investors have shown they will pay a higher premium for LICs that consistently deliver high, reliable dividend yield.

Chart 1: WAM Capital

Source: ASX, 19 March 2015

2. Russell High Dividend Australian Shares ETF

Exchange-traded products (ETP) that aim to replicate the price and yield of an underlying index have two key benefits for income investors. The first is diversification: the Russell yield ETP, for example, is based on an index that comprises 50 securities. The second benefit is low cost: the ETP's annual management cost is 34 basis points, well below that of unlisted managed funds.

The Russell ETP has a 12-month trailing grossed-up yield of 6.49% (after 78% franking) – about 80 basis points better than the S&P/ASX 300's average grossed-up yield. The index has been custom-designed to provide higher yield from large-cap companies.

Russell's grossed-up yield is comparable with Commonwealth Bank's, and the ETP has less risk because it is based on 50 stocks. Investors who view the big banks and Telstra like income-producing bonds, rather than higher-risk equities, could do worse than consider an ETP that provides a similar yield, without the single-stock risk.

Chart 2: Russell High Dividend Australian Shares ETF

Source: ASX, 19 March 2015

3. Contango MicroCap

Micro-cap stocks might seem an unusual source of dividend yield. Capital-hungry small companies typically reinvest more of their profits to aid faster growth, rather than give funds back to shareholders

through dividends. And they are often too risky for income investors.

That is true of many micro-cap stocks. But higher-quality micro-caps, such as listed software service providers, often have capital-light business models and are able to pay higher dividends. Or they are well established and do not need significant capital investment to grow.

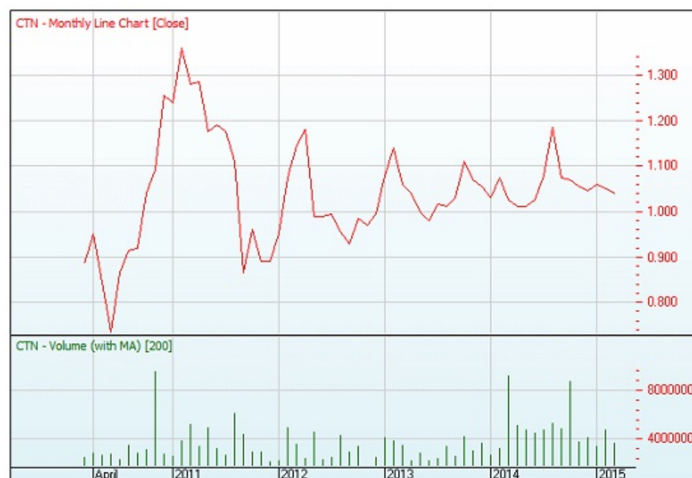
Another LIC, Contango Microcap, specialises in small- and micro-cap stocks. It had an 8.2% trailing dividend yield at February 28, 2015, ASX data shows. Contango declared a 4% interim dividend for the first half of 2014-15 — 50% franked (up from 25% franking in 2013). At $1.05, its annualised net yield is 7.6%, or 9.2% after partial franking.

As with other LICs, Contango offers exposure to a basket of micro-cap stocks, thus improving portfolio diversification. Moreover, it's worth paying fees for professional management in the sometimes treacherous world of micro-cap investing.

Contango traded at a 7.1% discount to pre-tax NTA in February 2015, ASX data shows, meaning its assets can, theoretically, be bought for less than they are worth. Contango arguably should have some discount factored in, given the lower liquidity of its underlying micro-cap portfolio. But it is still cheaper than many other LICs that trade at a premium to NTA.

As the Australian economy improves in 2016, and as a rising equity market attracts more investors, small- and micro-cap industrial companies should collectively perform better, meaning Contango could narrow the gap to NTA in the next year or two.

Chart 3: Contango MicroCap



Source: ASX, 19 March 2015

- Tony Featherstone is a former managing editor of BRW and Shares magazines.

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Yield still king and NAB wears the crown

by Charlie Aitken

Key points

- *Company dividend payout ratios are rising, which is leading to a double-whammy re-rating of predictable dividend stream equities.*
- *High-conviction stock ideas for non-bank dividend growth include AMP (AMP), Automotive Holdings (AHE), APA Group (APA), ASX (ASX), Auckland Airport (AIA), Challenger (CGF) and Goodman Group (GMG)*
- *NAB's two decades of "diworsification" is ending and a two-year price target of $45.60 is not out of the question.*

The Fed has pleased Wall St by again saying they are in no great rush to raise US interest rates. US Fed Funds Futures now point to the first US interest rate rise in October, a full six months from today.

Rate outlook

This year, 24 central banks have cut rates and the Fed is pushing out its cash rate raising timeline (again) mainly due to US dollar strength. That means for the next six months, the monetary policy taps are turned on fully globally and the effect on risk asset prices will be material, as I have been writing.

Let's start by reminding ourselves of current first world cash rates and bond yields.

Country	Cash rate	10yr bond yield
USA	0.125%	1.92%
Australia	2.25%	2.36%
United Kingdom	0.50%	1.59%
Germany	0.05%	0.19%
France	0.05%	0.47%
Canada	0.75%	1.32%
Sth Korea	1.75%	2.26%
Japan	0.10%	0.35%

You can see the effect on risk asset prices of liquidity pumping. The **dash from cash** is accelerating globally, with anyone who relies on investment income to live basically forced into equities.

There remains absolutely no doubt in my mind that the cash rates and bond yields we see in front of us today will continue to lead to equity dividend yields being bid down, leading, inversely, to further capital gains in the right equities. That is why, twice already this year, **I have lifted my ASX200 trading range (currently 5700-6200)** on the basis of global and domestic demand for high equity dividend yields.

Not only is demand for equity yield increasing, the corporate world is paying out a greater proportion of earnings as dividends. Payout ratios are rising, which is leading to a double-whammy re-rating of predictable dividend stream equities. I have written it numerous times before, in fact, I was the first to ever write it in relation to Australian banks and Telstra, but I am convinced for the medium-term that any equity with bond like characteristics is going to be priced like a bond: i.e. inverse to its yield.

That strategic thesis is proving right and I am going to stick with it despite all the howls from equity valuation

purists. My view is we have never seen cash rates and bond yields this low, so there is no historic playbook to what comes next. Historic valuation and share price target setting approaches are somewhat obsolete, perhaps even dangerous in the short-term, in a world where central banks are so dominant. My job is to predict how investors react to macro settings and how and where capital will flow.

All the major central banks continue to embrace zero interest rates and either existing, or new, QE polices. As a result, in a low interest rate, low return environment, where cash continues to be undermined as an asset class, I expect equities will continue to outperform as an asset class, and yield will command a premium. As a result, I continue to recommend investors buy fully franked dividend yield.

Pullback play

It's also worth noting that **the bottom of my upgraded ASX200 trading range (5700-6200) held during the recent Wall St and ex-dividend pullback.** The ASX200 saw a low of 5748 and has bounced 150 points since, led by anything with a reliable dividend yield and despite resource stocks going backwards. In my view, this bounce from 5748, led by yield stocks, confirms that a wall of cash underpins Australian equities and that unsatisfied wall of cash will be put to work in Australian equities with the right income attributes over the months ahead.

Domestic and global rotational money is now targeting Australian sustainable yield equities in a world where fixed income yield above 0% real is almost impossible to find. I remain of the view that we may all be surprised how low equity dividend yields get bid down to in the months and years ahead as the world hunkers down into an extended period of ultra-low cash and bond rates.

The good ideas

My high conviction yield compression ideas remain:

Major banks

- ANZ (ANZ)
- National Australia Bank (NAB)
- Westpac (WBC)

Regional banks

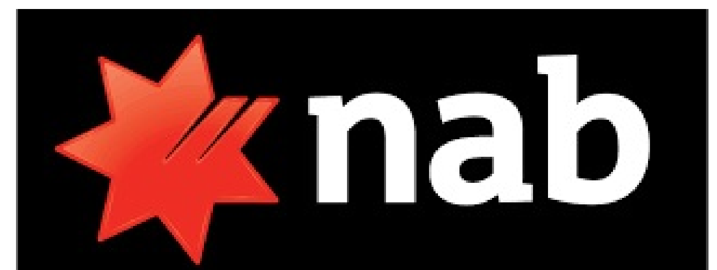
- Bank of Queensland (BOQ)

Non-bank dividend growth

- AMP (AMP)
- Automotive Holdings (AHE)
- APA Group (APA)
- ASX (ASX)
- Auckland Airport (AIA)
- Challenger (CGF)
- Goodman Group (GMG)
- GPT (GPT)
- IAG (IAG)
- IOOF (IFL)
- Medibank Private (MPL)
- Perpetual (PPT)
- Sydney Airport (SYD)
- Transurban (TCL)
- Suncorp (SUN)
- Tabcorp (TAH)
- Telstra (TLS)
- Wesfarmers (WES)
- Spark New Zealand (SPK)

The bank view

Today, I want to revisit the **National Australia Bank (NAB)** investment thesis as we head towards the 1HFY15 reporting and dividend season for the Australian banks in May.



Let me just start at the top down level regarding Australian banks. I see some of my strategy competitors have moved to "sell" recommendations on Australian banks. Personally, I think that is massively premature.

Australian cash rates are at record lows and heading lower. Back on the 20th of January I UPGRADED the Australian bank sector and reverted to using 5.00%

fully franked FY15 yield based share price targets for the majors. AGB 3yr bonds were 2.07% back then and the cash rate 2.50%. The table below was from that Jan 20th note.

5.00% ff FY15 dividend yield based share price targets

Bank	FY15 div (est)	5% ff yield target FY15	% gain from current SP
ANZ	189	$37.80	+20.9%
CBA	428	$85.60	+2.4%
NAB	210	$42.00	+25.8%
WBC	190	$38.00	+15.9%

Click here *to view larger image*

Fast forward to today and CBA and Westpac have exceeded those 5.00% fully franked FY15 yield based share price targets and ANZ and NAB remain below them. In fact, CBA's FY15 yield has been bid down to 4.52%, making 5.00% fully franked targets for ANZ and NAB seem highly achievable in the not-too-distant future.

The self-fulfilling virtuous circle of bank equity demand in an ultra-low interest rate environment™

National Australia Bank

At current prices I think NAB is the best total return buy of the big four Australian banks. It has the greatest scope for P/E re-rating and greatest scope for dividend growth and in turn, dividend yield compression.

Let's not over-complicate this: **NAB's two decades of "diworsification" is ending. Yes, that's my term, "diworsification".**

On that basis, I believe NAB's two decades of share price underperformance vs. its peers will end.

New CEO, Andrew Thorburn, is moving at pace to shed underperforming, low return on equity (ROE) businesses. His is physically taking the noose off NAB's share price neck.

Since he has taken the helm, it's pretty clear **the UK banks are on the chopping block, Great Western Bank is going, and MLC will be sold. That will return NAB to its rightful place in the cosy Australian major bank oligopoly, where consistent dividend growth is generated.**

Interestingly, NAB shares have broken the 10yr downtrend since Thorburn started talking sense (from the first day he took over). However, they remain well below the all-time high of $44.84

Outlook

Let's now look at what I forecast for NAB for the next two financial years. Multiples are based off last night's NAB closing price of $38.38.

NAB	FY15	FY16
NPAT	$6.4B	$7.4B
EPS	267c	303c
EPS growth	22%	13%
P/E	14.2x	12.5x
P/B	1.7x	1.6x
NIM	1.90%	1.90%
ROE	14.10%	15.30%
DPS	210	228
YIELD	5.52%	6.00%
GROSSED UP YIELD	7.88%	8.57%

It's worth noting my all-important dividend forecasts are ahead of current consensus for both FY15 and FY16. I forecast 210c fully franked for FY15, the market is currently @205c fully franked, while for FY16 I forecast 228c fully franked, and the market is currently @212cff. I am happy to back NAB's ability to pay above market dividend forecasts as non-core assets are shed at pace.

I believe the market will eventually bid NAB down to a 5.00% fully franked FY16 dividend yield, as the company simplifies and lifts its ROE.

On that basis, and as I believe Australian cash rates will move lower over the next two years, **I am setting a 2-year price target on NAB of $45.60** (228c ÷5%).

I believe you can buy and hold NAB for the next two years and collect a total of 438c fully franked in dividends, or 625c grossed up. I also believe there's the potential for $7.60 of capital gains, taking the prospective pre-tax total return to $13.85, or 36.4% over the next 24 months.

Even if I am wrong and there is no capital gain, the grossed up 2yr yield of 16.4% is massively compensating you for equity risk versus a likely cumulative cash rate over that period of 4.00% and AGB 2yr bond yield of 1.82%.

That yield could also be potentially enhanced by a tactical covered call option writing over ex-dividend periods.

NAB's "diworsification" cost all shareholders relative and absolute performance: NAB's "simplification" will drive a recovery of lost share price performance

NAB remains a core high conviction buy with a 2-year price target of $45.60

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What will happen when Warren Buffett goes?

by Barrie Dunstan

Warren Buffett's Berkshire Hathaway has long been worshipped by many and its chairman lauded for his investment wisdom, laced with homespun humour.

But, for all those devotees who adore him as a disciple of the father of value investing, Ben Graham, or those who use his name to sell investment schemes and advice, this year's version of his annual letter to shareholders was something of a revelation.

Sure, there were the usual zingers: "You see a cockroach in your kitchen; as the days go by, you meet his relatives," and "if horses had controlled investment decisions, there would have been no auto industry." But, marking its 50th year, Buffett and vice chairman Charlie Munger have reflected on Berkshire Hathaway's growth into a completely new beast.

The new order

They provide a clear view of the group's success – and how much it has changed. Previously, it was invested in listed securities; today it emphasises owning and operating large businesses. It is now probably the world's most successful conglomerate, with 340,500 employees and capex spending of $US15 billion. It is, in Buffett's words, "a sprawling conglomerate – trying to sprawl further."

Berkshire now has four main arms, headed by what Buffett calls the Powerhouse Five – the railways and utilities mainly bought in the last decade – which in 2014 contributed $12.4 billion in profits (all figures $US and pre-tax).

Then there are its smaller industrials with $5.1 billion profits, and the insurance group with $2.7 billion of profits (but more importantly generating $84 billion in its "float").

To that add the group's listed investments, notably IBM, Coca Cola, Amex and Wells Fargo bank, which alone had $4.7 billion of equity accounted profits, though Berkshire only recognises $1.6 billion of dividends. The top 15 listed investments had a market value of $117.5 billion (they cost only $55 billion).

As a reminder of Buffett's investment smarts, it also has a "call" option over 700 million Bank of America shares with a market value of $12.5 billion, a deal done in the GFC when only Berkshire had capital to invest. It paid $5 billion for the option.

The 2iC

Before he met Munger, Buffett says he had Berkshire investing like someone picking up cigar butts. Then in 1959 the two were introduced (Buffett was 28 and Munger 35) and the partnership blossomed. In over 50 years they may have disagreed but never argued.

Usually, says Buffett, Charlie ends by saying: "Warren, think it over and you'll agree with me because you're smart and I'm right." Munger's philosophy produced the blue print, which has seen Berkshire develop into a major US industrial powerhouse.

Previously, it was about "buying fair businesses at wonderful prices" – Ben Graham's recipe of buying shares well below their intrinsic value. Under Munger's guidance that switched to "buying wonderful businesses at fair prices."

Berkshire's cash-generating insurance arm and canny husbanding of cash (now around $60 billion in cash or Treasuries) has led the group into partnering other groups in acquisitions. While this continues, Buffett suggests shareholders can forget about dividends for perhaps 10 to 20 more years before

cash becomes too large.

First it joined the 3G Capital group to acquire Heinz, and it expects to participate in other activities, usually as an equity partner. It also has similar partnerships with Mars and Leucadia (often called baby Berkshire Hathaway).

Now it has moved into the unfashionable field of car distribution, buying the fifth largest group in the US – and looking to expand in this area.

Buffett wants to make more “bolt on” acquisitions, both large and small, and hints that acquiring an occasional Fortune 500-size company isn’t out of the question – obviously to make a major impact to earnings.

Succession planning

And when Buffett goes? Munger says potential replacements Ajit Jain and Greg Abel are “world-leading” performers who in some important ways may be better than Buffett.

The group has been carefully grooming the executives who will take over. Of Jain who runs the reinsurance business, Buffett says his underwriting skills are unmatched and “his mind is an idea factory that is always looking for new lines of business.”

He also has given the two investment managers, Todd Combs and Ted Weschler, oversight on at least one operating business as chairman, to add business management to their investment management skills.

And just in case shareholders need an example of the advantages of buying a great business, Buffet reminds them of See’s Candy bought in 1972. Berkshire paid $25 million, invested another $65 million –and has reaped cumulative profits of $1.9 billiion. Overall, Buffett says, “listening to Charlie has paid off.”

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Buy, Sell, Hold – what the brokers say 19/3/15

by Switzer Super Report

Merger, demerger and acquisition activity drove broker action this week, with analysts casting their eye over the TPG bid for iiNet and BHP's South32 spinoff.

In the good books

Citi upgraded BHP Billiton to Buy from Neutral. Buy/Sell/Hold 4/0/4. Citi upgraded following share price weakness and on the estimate that investors looking for yield can have some 5.5%, if they buy now or 6% if they wait until South32 has become a separately listed entity, which should happen by late May/June. Citi believes South32 post separation can become a high yielding stock in its own right, estimating a yield of circa 6% for the spin-off.

Macquarie upgraded Bluescope Steel (BSL) to Outperform from Neutral. Buy/Sell/Hold 7/0/1. Macquarie has updated FX forecasts, assuming a lower Australian dollar and euro versus the US dollar over the next couple of years. The broker has also made material cuts to near-term iron ore price forecasts. In the steel sector, BlueScope is the largest beneficiary of the changes to forecasts and the broker expects steel spreads to improve.

Credit Suisse upgraded iiNet to Outperform from Neutral and Morgan Stanley to Equal-Weight from Underweight following the TPG Telecom bid. Credit Suisse notes iiNet may declare a special dividend to pay out excess franking credits to shareholders. The broker upgrades on the basis that iiNet is trading below terms and offers a 16% annualised return through to deal completion. Morgan Stanley does not believe the ACCC is likely to block the bid and notes the new company would have a 27% retail broadband share, well behind the leader Telstra, which has 45%.

In the not-so-good books

Morgans downgraded iiNet (IIN) to Hold from Add. Buy/Sell/Hold 3/1/4. Morgans only recently upgraded to Add but has now pulled the rating back to Hold, following the bid by TPG Telecom at $8.60 a share. The broker now sets the target at $8.60, from $7.52. The broker notes iiNet board has the potential to distribute retained profits as a special dividend and the offer price would go down by whatever the cash component is.

Citi downgraded TPG Telecom (TPM) to Sell from Neutral. Buy/Sell/Hold 2/2/2. TPG's offer for iiNet has strong strategic logic, in the broker's view, and potential earnings accretion of 14% in year one. Still, the shares are priced for perfection while the deal is not yet completed, so the broker suggests it is better taking money off the table at current prices and downgrades to Sell from Neutral.

Morgan Stanley downgraded Wesfarmers (WES) to Equal-weight from Overweight. Buy/Sell/Hold 0/5/3. Morgan Stanley is downgrading to Equal-weight from Overweight on the back of slower growth at Coles. While its strategies are considered more sustainable than rival Woolworths, the broker contends it is not immune to the weaker industry outlook.

The above was compiled from reports on FNArena, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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My SMSF - the time was right for rebalancing

by Ron Bewley

Each month I model, but don't necessarily invest in, a new hybrid yield-conviction portfolio for myself to ponder over. My expectation when I 'got set' around June 2014 was that I would hold (without trading) for at least three months unless something really drastic happened. But I fully intended to rebalance into a new portfolio within 12 months, so as to keep it fresh.

Readers might recall that I recently started an international exposure in my SMSF but that exposure came from selling down stocks from my 'other' portfolio and not my hybrid yield.

By so doing, I got my international exposure up to 30%, as I flagged I wanted to last month. And then I even 'over-achieved' by getting that exposure up to 37%, all in the unhedged iShares Core S&P 500 ETF (IVV). Rebalancing my hybrid portfolio was a separate exercise that, through a number of separate circumstances, happened at the beginning of March.

Hybrid rebalance

The first thing I noticed was that the portfolio's performance started to slip a little against the ASX/S&P 200 benchmark.

The second point was that all of the high-yield sectors, plus health, were seriously overpriced using my exuberance measures, suggesting a correction or a prolonged sideways movement, might be imminent. The ASX/S&P 200 was less overheated at about 4.5% and below the 6% level I use to call a correction.

The new (March) portfolio contained only 12 stocks, rather than the 15 I was holding, because my filters again couldn't find enough good stocks to populate the new sectoral allocation. Moreover, some of my June stocks had consensus broker recommendations that had slipped below a '3', which is a hold.

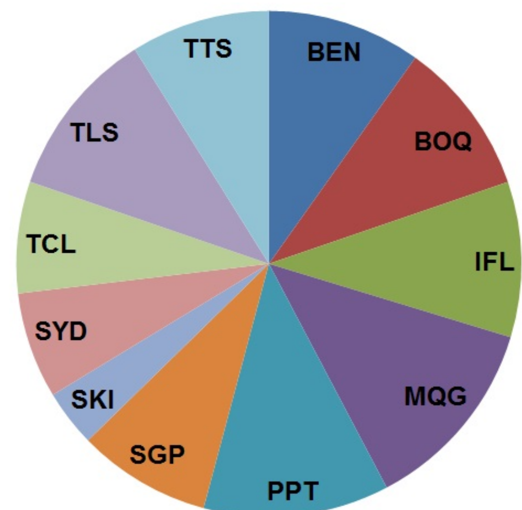
Out with the old

So Duet (+2.2%), Federation Centres (+18.5%), Primary Health Care (10.1%) and Suncorp (+0.5%) had to go – where the percentages in parentheses denote the capital gains over the eight months or so. Of course, they all paid dividends as well.

Tatts should have been replaced by Tabcorp – a similar sort of company – but I chose to ignore that. Tatts (+31.9%) had done particularly well and its broker forecasts had just been updated and were slightly better than those for Tabcorp.

Two new stocks were added: Alumina and Perpetual. In essence, Perpetual replaced Suncorp and Alumina entered because a materials stocks at last could enter the portfolio. Four stocks (Spark Infrastructure, Stockland, Transurban and Telstra) attracted significant additional funding. Other rebalances were suggested but they were too small to justify the effort and cost of that part of the rebalance. The new portfolio is shown in Chart 1.

Chart 1: The new Hybrid Yield-Conviction Portfolio



Source: Woodhall Investment Research

The new portfolio has not been running long enough to justify a performance check but it is currently ahead of the benchmark since the rebalance.

So my current SMSF is 31% Hybrid, 37% international, 30% other and 2% Cash. Fortunately the ‘other stocks’ I sold to fund the purchase of IVV have since fallen 2.7% while IVV has only lost 0.3% so that’s 3.0% on the trade.

The strategy

I sold some of those same stocks from my margin loan (outside of my SMSF) at the same time to reduce debt – or de-risk. My geared iShares MSCI Australia 200 ETF (IOZ) and IVV portfolio I write about (and discussed on Switzer TV on the 11th March) now constitutes about 75% of that portfolio. The margin loan stocks I sold would have lost me 7.9% had I not sold them!

My point here is not to try to show I have some special intuition. Rather the opposite, all of my recent trading was based on my mispricing measures (which I publish each week in the Woodhall Weekly) and my quantitative, logical consistent assessment of broker data that defines my portfolios. As you can tell, I am prepared to make some slight qualitative modifications to save effort. But I put my money where my mouth is and, of course, sometimes I make poor decisions in hindsight – like everyone else.

I have no expectations to trade again this financial year in my SMSF other than to possibly take up the Macquarie offer and whatever might come out of the BHP divestment. Indeed, I might not trade again until Christmas. On the other hand, I might sell IOZ or IVV if their respective indexes rise too high in my geared portfolio.

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Relief for excess non-concessional super contributions

by Tony Negline

Key points

- *The ATO will notify you of excess concessional contributions and depending on what you decide to do with them, will then send you notification of excess non-concessional contributions.*
- *You have 60 days to then tell the ATO what you want to do with those NCC but you are now able to have the money refunded to you.*
- *These new rules can potentially help superannuants enlarge their tax-free components in super.*

In some great news, any excess non-concessional super contributions that you make after June 2013 can now be taken out of the super fund and will not face tax penalties.

This is a welcome new law, however there is an interesting twist, which potentially adds a bigger benefit, which I'll explain in a case study below.

The new process

Firstly I'll show you the overall process that is used to determine how your excess concessional and non-concessional contributions are treated:

1. Super funds deduct 15% contributions tax for all concessional contributions each year in the normal way.
2. Super funds send contribution information via a member contribution statement (APRA regulated funds) or annual returns (SMSFs only).
3. The Tax Office determines if a person has excess concessional contributions (ECC).
4. If applicable the ATO sends documentation about ECCs to a taxpayer and notifies them of their options:
   a. Apply for "special circumstances" – that is, apply to disregard or reallocate the contributions (in reality this option has had limited success)
   b. Release up to 85% of the contributions – these contributions plus a late interest penalty will be taxed at marginal rates, less a 15% tax offset for any tax already paid
   c. Do nothing – excess contributions will be taxed at your marginal rates less the 15% tax offset for contributions already taxed
5. You must decide what to do within 21 days of receiving the Tax Office's notice (or longer if the Tax Office allows). You must nominate the super funds that are to have contributions released.
6. Excess concessional contributions that remain in a super fund are counted towards your non-concessional contribution (NCC) cap. Any ECCs that are refunded to you under this rule will cause a reduction in the ECCs counted towards your NCC cap.
7. Next the Tax Office determines if you have any amount above the NCC cap, that is you have excess non-concessional contributions (ENCCs) and if applicable it determines:
   a. Associated earnings – deemed earnings from the start of the financial year in which a contribution is made until the date of calculation by the ATO; these earnings are determined using the General Interest Charge rate which is currently 9.36% per annum (further details of this rate can be found at this link).
   b. "Release amount" – ENCC plus 85% of associated earnings
8. ATO notifies the taxpayer of their options:
   a. Special circumstances – apply to disregard

or reallocate contributions.
b. Release – have all excess amounts plus associated earnings released from nominated super fund.
c. No money left in the super system – advise and prove that you have no money left in the superannuation system.
d. Do nothing – decide to have ENCCs taxed at penalty tax rates.

9. You have 60 days to decide which option you wish to select (or longer if the Tax Office allows)

Case Study

Mary is aged 58 and has $500,000 in super of which $150,000 is in her tax-free component.

On 1 December 2014 she made a $700,000 non-concessional contribution. This means she now has $1.2 million in super of which $850,000 is in her tax-free component.

On 20 June 2016, the Tax Office determines that Mary is eligible for the three-year bring forward NCC cap of $540,000. Therefore she has ECNCCs of $160,000.

The associated earnings on this amount are $31,844 (I have made a very rough estimate of what this amount might be).

The Tax Office gives Mary the four options mentioned above including that she can withdraw $187,067 from super (that is, $160,000 plus $27,067 which is 85% of the $31,844 in associated earnings). The $27,067 is taxed at her marginal rates.

She decides to withdraw the $187,067 and nominates her super fund, which holds these contributions.

When this amount is withdrawn it is taken from her taxable component. Only once the taxable component is exhausted will money be taken from her tax-free component.

Ignoring earnings and changes in capital values to Mary's super investments during the intervening period, after the withdrawal she will have $1.02 million in super. The tax-free component remains at $850,000 and the taxable component has been reduced to $162,933.

In effect, we potentially have another means of enlarging the tax-free component (the traditional way is to take money out of super and re-contribute it as a NCC).

Some downsides with this strategy:

1. The associated earnings are taxed at marginal rates – this tax must be considered when determining which strategy is best.
2. When money is taken out of super, it must first be removed from the unrestricted component. If Mary has any unrestricted money, then the withdrawal of excess contributions might limit her ability to take money out of super prior to officially retiring. If access to this money is important, then this will be a factor that has to be considered.
3. Some have argued that this "strategy" might be "tax avoidance". If you have any concerns about that then you might like to get some good advice or even apply for a Binding Income Tax Ruling from the ATO.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Sydney Airport and withdrawing pensions

by Questions of the Week

Question: Charlie Aitken suggested Sydney Airport as an option for a falling dollar and growing tourism. It seems worthwhile, but I am very concerned about the high debt it carries (82% of capital) and low return on equity. Should I be? Or does the nature of Sydney Airport being a long-term monopoly change the way you look at debt being carried?

Answer (By Paul Rickard): I don't think you need to be unduly concerned. Sydney Airport has been structured as an infrastructure style investment, which often means high levels of debt and a smallish capital base.

The annuity style revenue stream, plus effective monopoly, provide enormous insulation and protection.

A downturn may see revenues for Sydney Airport fall by low single digit percentage – whereas a downturn for a normal business may see revenues fall by 20% to 30%. Because the revenue risk is so much lower, the market allows it to carry a much higher gearing level.

Question 2: I have an allocated pension from which I receive pension payments. Occasionally, I withdraw extra funds, which I have treated as an advance pension payment. What is the difference between classification as an advance pension payment and as a commutation both now at age 64, and on receipt of a partial old-age pension at 65?

Answer 2 (By Tony Negline): Before 65, lump sum withdrawals are split between your tax-free/taxable split components, determined when your pension commenced (or on 1 July 2007 if your pension commenced before then). On the other hand, all income payments are taxed at marginal rates less a tax offset.

After age 65, all lump sum and pension income payments are tax-free.

All lump sum withdrawals will impact your Centrelink Deductible Amount (used to reduce the amount of income counted under the income test if your pension commenced before January 2015).

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