PART 1 - INCOME DISTRIBUTIONS FROM UNIT TRUSTS

Gavin Shepherd
Portfolio Construction & Investment Research Manager

What should you expect?

It is anticipated that the level of income distributions received by unit holders of many managed investments may be lower in the 2016 financial year.

As many of our clients are aware, the domestic and international share markets experienced significant growth over the 2015, 2014 and 2013 financial years (see table 1). In turn, this growth has been reflected in the capital growth of many shares listed on these markets. For example, a company that was worth $100 may now be worth $200, a capital gain of $100.

Income distributions includes the income (e.g. dividends, interest etc.) received from the underlying investments. It also includes any capital gains or losses realised in the fund. Realised capital gains will increase the income distribution whereas realised capital losses may reduce income distributions. Capital gains are more likely to be achieved when financial markets are performing well and vice versa.

The strong returns experienced by financial markets have had the effect of increasing the realised net capital gains component of the income distributions of many managed investments. For example, in the 2015 financial year the Magellan Global Fund paid out an unusually large income distribution of 24.34 cents per units (CPU). It was not surprising that realised net capital gains made up a large proportion of this income distribution (see table 2).

It is unlikely these high levels of capital gains experienced in the 2015 financial year will be repeated in the 2016 financial year. As shown in table 1, total returns for the 11 months to the end of May 2016 from international shares has been substantially lower than the previous few years.

Table1: International and Australian Share Market Returns Financial Year

Share Markets	11 months to 30 May 2016	2015 Financial Year	2014 Financial Year	2013 Financial Year	2012 Financial Year
International Shares*	5.11%	23.02%	19.24%	29.34%	-1.47%
Australian Shares**	4.30%	6.31%	16.38%	20.53%	-8.76%

* *MSCI World ex Australia Accumulation Index NR (A$)*
** *S&P/ASX 300 Accumulation Index (Total Return)*

In summary, historical growth experienced by these markets may not be sustainable. This may result in a decline in the level of realised capital gains paid to investors and in the total distributions paid to investors.

<u>Consequently, you should not be relying on income distributions from certain managed funds (particularly international shares and alternative assets) to be at a similar level to previous years.</u>

What is a distribution?

In simple terms, an income distribution is an amount of cash that the unit trust pays to the unit holder.

Income Distribution components

Income distributions from unit trusts are made up of a number of components. These include:

- investment income (e.g. dividends) received from the underlying investments
- any tax benefits (e.g. franking credits) attached to the investment income
- any net realised capital gain. Net realised capital gain is equal to capital gains (i.e. the security has been sold for a price higher than it cost the fund) minus capital losses (i.e. the security has been sold for a price lower than it cost the fund)

Regularity of Income Distributions

Under Australian taxation law, the manager must distribute all their taxable income each financial year. The timing of these distributions may vary from quarterly to semi-annually (i.e. every six months) to annually.

What factors may affect the level of income distributions?

Dividends distributed by the company to shareholders

Dividends distributed by the company to shareholders may vary due to:

1. a change in the growth rate of the company's earnings; and/or,
2. the proportion of earnings paid out in dividends i.e. how much of earnings the company retains and how much the company pays out in dividends

Net Capital gains (Capital gains minus Capital Losses) are realised

Another contribution to the level of income distribution is net realised capital gain (especially important for international managed share funds and alternative assets). When a fund sells an asset or stock they realise either a capital loss or a capital gain. Any net realised losses cannot be distributed to unit holders.

The level of income distributions that the investor receives from the fund will therefore depend on:

- the level of capital losses and capital gains i.e. how well the portfolio manager picks securities that outperform as opposed to underperform; and
- how often the fund manager turns over the portfolio i.e. how often and actively the portfolio manager of the fund sells and buys securities. More active fund managers tend to have higher turnover in the fund and therefore tend to realise gains and/or losses more frequently. This results in distributions generally being higher and more volatile relative to more "buy and hold" strategies;
- Franking Credits.

The level of franking credits depends on the following:

- the level of franking credits distributed by the underlying shares
- the company tax rate which influences the level of credit
- the proportion of realised gains in the distribution. If a large component of the distribution is realised capital gains than the overall franking level for the distribution will be lower. This factor tends to create the greatest volatility in franking levels.

Historical income distributions of recommended equity trusts and alternative assets

The table below shows a sample of Logical's Australian and International share strategies and Alternative assets. Some of the observations include the following:

International Shares

Magellan and Platinum (International and Asia) have paid out relatively high levels of income in the last two financial years due to net realised gains.

Walter Scott is a low turnover manager and therefore can expect little in the way of net realised capital gains and therefore income distributions.

Australian Shares

The level of income received by the client depends on the fund managers investment style (i.e. level of active management and turnover of the portfolio) and objective of the fund (income – franking credits vs. capital growth focus).

Alternative Assets

Unit holders received a substantial income distribution from AQR and Aspect in the 2015 financial year. Unit holders need to be aware that income distributions will vary significantly from 0.0 cpu to a high in 2015 financial year of 21.90 cpu (Aspect) and 42.57 (AQR). It is highly unlikely that the 2015 financial year distribution will be repeated in 2016.

Table 2: Historical Financial Year (2009-2015) Distributions (CPU) for a sample of Logical's managed Australian and International Share trusts and alternative assets trust

Funds	2015	2014	2013	2012	2011	2010	2009
International Shares							
Magellan Global Fund	24.34	5.99	3.25	2.00	1.75	1.50	1.74
Platinum International Share Fund	20.21	11.12	4.30	2.40	4.17	0.00	30.92
Walter Scott Global Equity Fund	0.87	0.81	1.00	0.71	0.55	0.58	1.32
Antipodes Global Fund	2.10	-	-	-	-	-	-
Platinum Asia Fund	53.16	17.84	4.69	2.02	2.36	6.54	17.43
Australian Shares							
Plato Australian Shares Income Fund	8.82	7.91	7.52	-	-	-	-
Investors Mutual Australian Share Fund	11.68	16.66	10.21	10.10	10.75	8.02	10.40
BT Wholesale Core Australian Share Fund	22.68	8.37	7.30	6.42	5.35	4.35	6.47
Hyperion Aust. Growth Companies Fund	9.69	7.20	6.46	7.50	5.51	4.67	6.35
Hyperion Small Growth Companies Fund	0.57	0.51	1.19	4.99	5.96	3.08	5.08
Perpetual W'sale Industrial Share Fund	34.31	56.58	6.84	6.75	6.81	5.40	7.03
IML Equity Income Fund	8.22	7.61	8.03	8.40	10.29	9.02	1.50
State Street Australian Equity Fund	3.95	9.87	11.44	5.21	4.33	0.85	
Alternative Assets							
AQR Wholesale Managed Futures Fund	42.57	2.06	9.99	0.00	0.00	-	-
Aspect Diversified Futures Fund Class A	21.90	0.00	0.00	10.81	2.40	0.00	-

What are the implications for your portfolio?

The higher levels of portfolio income realised in 2015 financial year is unlikely to be repeated in the 2016 financial year.

International shares should not be relied on to provide you with a stable level of income over the long term. In contrast to Australian share funds, the dividend component of the distributions is likely to be much smaller, often less than 2-3% p.a. and is not tax effective. Therefore, in a falling market, where realised capital losses exceed capital gains, distributions can be reduced to close to zero. In other words, the amount of net realised capital gains in an international trust is the main variant in the income distribution. For this reason, international share funds should not be relied upon to provide income in the short term and especially not to meet your essential spending needs.

International shares should be used in your portfolio for the following reasons: strong returns over the long term (grow capital), protection against inflation, correlation benefits with other asset classes (and underlying investments in your portfolio), a reduction of country specific risk and greater liquidity.

Australian Shares may be used in your portfolio to generate more stable income returns through higher level of dividends (dividends, interest and net realised capital gains) and provide tax benefits by way of franking credits. Unlike International shares, Australian shares are treated favourably in terms of taxation. This is through franking credits, which allows you to receive a tax credit if a company has already paid full company tax (subject to your marginal tax rate). You can maximise your tax-effective income by investing in those funds with a good likelihood of producing consistently high franked distributions.

Logical recommend funds that aim to provide a high level of income (that includes franking credits) that exceeds the yield (income) of the Australian share market (S&P/ASX 200). These types of strategies are tailored for clients in their pension phase due to the favourable tax treatment.

Alternative assets should not be relied on in your portfolio to generate income to meet your essential expenses. Similar to International Shares, net realised capital gains in an alternative asset fund is the main variant in the income distribution. Alternative assets should be used in your portfolio for the following: favourable diversification benefits in your portfolio and growth of your capital over the long term. These types of strategies can be used as the growth component of your portfolio, whether you're in an accumulation, pre-retirement or pension phase.

Kate Cramsie
Financial Adviser

PART 2 - PROPOSED BUDGET SUPER CHANGES - UPDATE

The budget superannuation changes are still proposed measures only and need to be legislated before they become law. Since budget night the government has released some fact sheets offering some further details about how their proposed changes will operate. There are still many details missing and the government has admitted that some 'tweaking' of the proposals will be required.

The following outlines some further details that have been provided since budget night:

$500,000 lifetime non-concessional contributions (NCC) cap

- This will be indexed to AWOTE in $50,000 increments.
- Where NCCs made between 1 July 2007 and budget night (7:30pm AEST 3 May 2016) exceed $500,000, no further NCCs may be made, however, existing NCCs may be retained in superannuation.
- Contributions which count towards the CGT small business cap ($1.395 million on 2015/16) will not count towards the $500,000 limit.
- The Government has also clarified that the current exemption for personal injury compensation payments will be retained and exempt from this lifetime NCC cap.
- The ATO can calculate the NCC amount for all superannuation fund members (from 1 July 2007 to 30 June 2015) where individuals and superannuation funds have met their lodgement obligations. Individuals can call 13 10 20 or write to ATO, GPO Box 9990 in any capital city. Phone requests will be responded to within 48 hours via a call back service. Written requests will take longer.

$1.6 million transfer balance cap

- The limit will be indexed to the Consumer Price Index (CPI) in $100,000 increments.
- Income streams will be assessed against the limit on the later of: — 1 July 2017, for existing income streams; or — when the income stream commences.
- Income streams will be assessed on a 'percentage used' basis. For example, if the amount assessed against the limit on 1 July 2017 is $1.2 million, 75% of the cap will have been used, 25% of the cap will remain.
- Amounts in excess of the transfer balance cap may be retained in superannuation accumulation and withdrawals will remain tax free for those aged 60 an over.

Defined benefit income streams

To correspond with the $1.6 million balance transfer cap, the following limits will be placed on defined benefit income streams:

- Unfunded (government) schemes: The 10% tax offset available to those aged 60 and over will be limited to $10,000 p.a. (i.e. it will only apply to the first $100,000 p.a. of income). The balance will be taxed at marginal tax rates with no offset.
- Funded schemes: The first $100,000 p.a. of income will be tax free for members aged 60 and over; 50% of the balance will be taxed as ordinary income at the member's marginal tax rate. The fact sheet did not state what would happen to the 15% tax offset for those between preservation age and age 60.

The fact sheet did not state what would happen if a member has both a defined benefit income stream and an account based pension.

t 02 9328 3322
f 02 9328 3323
e team@lfma.com.au
w www.logicalfinancial.com.au

Suite 21, Level 2, 8 Hill Street, Surry Hills NSW 2010
PO Box 103
Darlinghurst NSW 1300