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An Examination of the Sustainability Disclosures of ANZ, NAB and Westpac
PAUL N. C. TIONG, Multimedia University, Jalan Ayer Keroh Lama, Malaysia
R. N. ANANTHARAMAN, Multimedia University, Jalan Ayer Keroh Lama, Malaysia

This research study examines the sustainability disclosures of the three Australian banks which prepared their sustainability reports in compliance with the Global Reporting Initiative’s (GRI) G3 Sustainability Reporting Guidelines and Financial Services Sector Supplement. This initiative became obligatory on 1 January 2010 for organisations that wish to achieve the highest level of disclosure. The results indicate that although the three banks achieved the highest level of disclosure, there were several areas that needed improvement.
26 Retail Investors and Ethical Investment
HOWARD PENDER, Australian Ethical Investment
MARIE BROCCHELTO, Australian Ethical Investment
Ethical and responsible investment markets have experienced phenomenal growth around the world in recent years and were relatively unaffected by the global financial crisis. This paper provides an overview of the framework for, and key issues involved in, ethical investing at the retail level in Australia. Ethical investment in Australia primarily involves screened portfolios, with limited activity occurring in community finance and shareholder advocacy.

32 Household Saving and Investing for Life-cycle Events: Government Incentives and Insurance Bonds
KEVIN DAVIS SF Fin, ACFS and University of Melbourne
ROSS HIGGINS, Austock Life Limited
DEBORAH RALSTON SF Fin, ACFS and Monash University
Individuals face difficulties in developing and executing optimal lifetime savings and investment plans, product complexity continues to grow, and there are increasing demands on government to support individuals’ financial needs. Within this context, this paper examines the rationale for government policies aimed at influencing household savings and investment decisions — focusing on the financing of life-cycle events and the design of suitable financial products to achieve desired outcomes.

38 Tax Distortions and Retail Investors
GORDON D. MACKENZIE F FIN, University of New South Wales
While tax distortions are traditionally measured using marginal tax rates, or real effective tax rates (Henry Review Panel), empirical studies have identified six margins where tax affects investment decisions. Measuring selected Australian savings vehicles against those margins highlights tax distortions affecting retail investor behaviour. These findings have significance for tax policy makers and financial institutions, and for the current policy debate about the standards of tax knowledge mandated for financial planners and the exemption from financial advice licensing for tax professionals.

43 Post-retirement Policy – a View
ROSS CLARE, ASFA
Much of the recent focus on superannuation policy outcomes and settings has related to the accumulation phase, and considerable work remains to be done regarding the post-retirement phase. Although the Henry and Cooper reports raised a number of important post-retirement issues, their recommendations provided only a partial response to the challenges involved. This paper outlines these challenges and provides potential policy options to address them.

48 Webmaster recommends
Update on ETFs and options, mortgage resources and tools, and corporate governance
This issue of JASSA includes important new research insights for practitioners on currency management and bank sustainability disclosure. It also contains a series of papers from the 16th Melbourne Money and Finance Conference.

The first paper, by Bin Li, Benjamin Liu, Robert Bianchi F Fin and Jen Je Su, examines the monthly seasonality of foreign exchange (FX) returns for eight major currencies (against the US dollar) from 1972 to 2010. It finds that five currencies exhibit significantly higher returns in the month of December and a significant reversal in January. With global FX daily spot transactions reaching US$4 trillion dollars, the authors note that these findings have important practical implications for currency hedgers, arbitrageurs and speculators.

The second, a study by Paul N. C. Tiong and R. N. Anantharaman, examines the sustainability disclosures of the three Australian banks which prepared their sustainability reports in compliance with the Global Reporting Initiative’s (GRI) G3 Sustainability Reporting Guidelines and Financial Services Sector Supplement. The authors suggest that although the three banks achieved the highest level of disclosure, there were several areas that needed improvement.

The remainder of this issue of the journal is devoted to papers from the 16th Melbourne Money and Finance Conference on Retail and Household Finance: Current Issues, which was held recently in Melbourne. An outline of these papers is provided in the introduction to that section of the journal. We thank both the sponsors of the conference and the authors for their contribution to this issue of JASSA.

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Monthly seasonality in currency returns: 1972-2010

This study examines the monthly seasonality of foreign exchange (FX) returns for eight major currencies (against the US dollar) from 1972 to 2010. It finds that five currencies exhibit significantly higher returns in the month of December and a significant reversal in January. Previous research has focused largely on the daily patterns within FX returns. With global FX daily spot transactions reaching US$4 trillion dollars, these findings have important practical implications for currency hedgers, arbitrageurs and speculators.

Keywords: foreign exchange markets, currency markets, market efficiency, market anomaly, monthly effect, seasonality.

Seasonality in financial markets (i.e. patterns over days, weeks, months and years) has attracted widespread attention and considerable interest among industry professionals and academics. For many decades, monthly seasonality of returns has been examined in stocks, debt securities, derivatives and even commodities. The most well-known seasonality comes from the US stock market literature where studies including Ariel (1987), Lakonishok and Smidt (1988), Ritter and Chopra (1989) and Dzhabarov and Ziemba (2010) have identified the presence of significantly higher returns in January than in other months of the year, which is commonly known as the ‘January effect’ or the ‘turn-of-the-year effect’. International evidence from Brown et al. (1983), Gultekin and Gultekin (1983), Li and Liu (2010) and Liu and Li (2011) have provided further support for the existence of these seasonal anomalies in monthly stock returns.

In the global foreign exchange (FX) markets, the presence of seasonal patterns would have important practical implications for banks, investors, multinational corporations and international trade in general. One of the first FX studies in the United States by McFarland et al. (1982) has shown that, on average, US dollar-denominated returns are higher on Mondays and Wednesdays and lower on Thursdays and Fridays. They conclude that a ‘Friday-to-Monday effect’ is due to an increase in the demand for the non-US currencies prior to weekends. Joseph and Hewins (1992) examine FX seasonality in the United Kingdom and Ke et al. (2007) examine similar effects in the Taiwanese FX market. These studies find significant variations in day-of-the-week returns, which are different from the results in US studies. The variation in the findings between the McFarland et al. (1982), Joseph and Hewins (1992) and Ke et al. (2007) studies are attributable to the differences in the start and end dates of each study and the asynchronous differences of the three major time zones (i.e. sampling FX data from the Asian, European and American time zones).

Other studies such as Copeland and Wang (1994) show that FX markets are more active when there is an upcoming holiday that is longer than a normal weekend. Furthermore, Copeland and Wang (1994) find that currencies exhibit greater volatility caused by an increase in trading when these longer holiday effects occur. After these holiday periods, FX markets are found to be quieter upon their re-opening. As FX markets are somewhat analogous to stock markets, FX returns may also possess forms of monthly seasonality. As stated in MacFarland et al. (1982), ‘in competitive financial markets, the prices which exist at a point in time reflect the interaction of a large number of suppliers and demanders, each of whom is reacting to a set of information that is pertinent to the assessment of returns and risks’ (p. 694). In the context of FX markets, the December Christmas and January New Year holiday period provides a set of events that are related
to extensive travel across countries for many individuals, tremendous levels of imports and exports in goods and services, large shifts in demand and supply of goods and services leading up to the Christmas period, and subsequent changes in demand and supply dynamics for these transactions in January. These calendar effects thereby cause rapid but temporary imbalances in goods and services and these transactions must be transmitted in the form of changes in demand and supply in FX markets. Given the importance of December and January in the calendar, we would expect that FX returns exhibit these temporary demand and supply imbalances in the form of specific patterns in monthly returns. This motivates us to investigate the monthly seasonality of FX returns in this study.

We investigate the monthly seasonal pattern in the returns of eight major currencies in the world, namely, the Australian dollar, Canadian dollar, euro, Japanese yen, New Zealand dollar, Swiss franc, Swedish krona and British pound. Our study covers the sample period from January 1972 to December 2010. We find that there are five currencies showing a significantly higher return in December than in other months. However, interestingly, the higher returns in these currencies are reversed in the month of January.

The remainder of the paper is organised as follows: Section 2 offers a description of the data and its summary statistics. Section 3 presents the analysis and findings. Section 4 provides concluding remarks.

Data

We employ monthly FX spot returns of six major currencies in the world that are the constituents of the US Dollar Index, namely, the Canadian dollar, euro, Japanese yen, Swiss franc, Swedish krona and British pound. Prior to the commencement of the euro (January 1999), we employ the German deutschmark as its proxy. The US Dollar Index is calculated by factoring in the exchange rates of these major world currencies based on a trade-weighted basis. As the Australian dollar and New Zealand dollar are frequently traded in the FX markets, we also include these two currencies, to examine a total of eight currencies in this study. We collect exchange rate data from DataStream for the period from 31 December 1971 to 31 December 2010 and convert the rates to ensure all values are expressed in their foreign currency. We calculate the US dollar denominated monthly return on the foreign currency at month $t$ as:

$$R_{i,t} = \ln \left( \frac{P_{i,t}}{P_{i,t-1}} \right)$$

where $P_{i,t}$ is the US dollar price of currency $i$ on the last day of month $t$, and $P_{i,t-1}$ is the US dollar price of currency $i$ on the last day of month $t-1$. As an example, if the AUD/USD spot FX rate in May is 1.04 and 1.05 in June, then Eq.(1) would calculate the June US dollar-denominated compound rate of return as $\ln(1.05/1.04) = 0.9569$ per cent.

Table 1 reports the returns of each currency spot market as US dollar returns. To measure all exchange rate uncertainties, we calculate the Sharpe ratio for each currency return series using the excess risk-free rate.

<table>
<thead>
<tr>
<th>Currency Code</th>
<th>Currency</th>
<th>Mean (%100)</th>
<th>Std. Dev. (%100)</th>
<th>Median (%100)</th>
<th>Min (%100)</th>
<th>Max (%100)</th>
<th>Skewness</th>
<th>Kurtosis</th>
<th>Jarque-Bera</th>
<th>p(1)</th>
<th>Float Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>AU/US</td>
<td>Australian Dollar</td>
<td>-0.03</td>
<td>3.23</td>
<td>0.05</td>
<td>-18.48</td>
<td>10.55</td>
<td>-1.14</td>
<td>5.87</td>
<td>774</td>
<td>0.05</td>
<td>12/1983</td>
</tr>
<tr>
<td>CN/US</td>
<td>Canadian Dollar</td>
<td>0.00</td>
<td>1.81</td>
<td>-0.03</td>
<td>-13.42</td>
<td>8.08</td>
<td>-0.59</td>
<td>7.92</td>
<td>1251</td>
<td>0.02</td>
<td>05/1970</td>
</tr>
<tr>
<td>EU/US</td>
<td>Euro</td>
<td>-0.04</td>
<td>2.98</td>
<td>-0.06</td>
<td>-10.79</td>
<td>9.12</td>
<td>-0.15</td>
<td>0.85</td>
<td>16</td>
<td>0.05</td>
<td>Note #</td>
</tr>
<tr>
<td>JP/US</td>
<td>Japanese Yen</td>
<td>0.29</td>
<td>3.31</td>
<td>0.00</td>
<td>-10.71</td>
<td>15.54</td>
<td>0.43</td>
<td>1.65</td>
<td>68</td>
<td>0.02</td>
<td>01/1973</td>
</tr>
<tr>
<td>NZ/US</td>
<td>New Zealand Dollar</td>
<td>-0.09</td>
<td>3.44</td>
<td>0.03</td>
<td>-24.85</td>
<td>13.06</td>
<td>-1.17</td>
<td>8.62</td>
<td>1555</td>
<td>0.03</td>
<td>03/1985</td>
</tr>
<tr>
<td>SW/US</td>
<td>Swiss Franc</td>
<td>0.31</td>
<td>3.54</td>
<td>0.18</td>
<td>-14.83</td>
<td>14.19</td>
<td>0.10</td>
<td>1.28</td>
<td>33</td>
<td>0.03</td>
<td>08/1971</td>
</tr>
<tr>
<td>SE/US</td>
<td>Swedish Krona</td>
<td>-0.07</td>
<td>3.17</td>
<td>0.14</td>
<td>-16.99</td>
<td>9.08</td>
<td>-0.74</td>
<td>3.22</td>
<td>245</td>
<td>0.11</td>
<td>11/1992</td>
</tr>
<tr>
<td>UK/US</td>
<td>British Pound</td>
<td>-0.10</td>
<td>2.98</td>
<td>-0.07</td>
<td>-13.12</td>
<td>13.61</td>
<td>-0.22</td>
<td>1.91</td>
<td>75</td>
<td>0.09</td>
<td>06/1972</td>
</tr>
</tbody>
</table>

Notes: The currency values are expressed as FC/US d, where FC is a foreign currency such as the Australian dollar. Jarque-Bera statistics for normality are all significant at the 5% level. The samples are monthly returns from January 1972 to December 2010. Note #: denotes the German deutschmark float date was March 1973 and the returns in this study reflect the German Deutschmark from January 1972 to 31 December 2001 and the euro from 1 January 2002 to December 2010.
movements in US dollars, we express the spot rate of each market as a foreign currency/US dollar rate. This ensures that all fluctuations in every spot market are expressed as a US dollar return. The summary statistics in Table 1 show that the mean returns vary across currencies with the Swiss franc reporting the highest mean return of 0.31 per cent per month and the British pound with the lowest at -0.10 per cent per month. The large Jarque-Bera statistics signify the rejection of the null hypothesis of normality. Finally, the first-order autocorrelation coefficients vary across currencies, with almost all of them less than 0.11 indicating that the currency returns are either weakly serially correlated or uncorrelated.

**Analysis and results**

We employ regression analysis to test the monthly effect hypothesis. First, we investigate whether the currency returns of each month are significantly different from zero. The regression model is specified as:

\[ R_{i,t} = \sum_{j=1}^{12} \beta_{i,j} D_{j,t} + \varepsilon_{i,t}, \]

where \( D_{j,t} \) is a dummy variable taking a value of one for month \( j \) and zero otherwise, \( j = 1 \) (January), 2 (February), 12 (December), \( \beta_{i,j} \) is a regression coefficient to be estimated and \( \varepsilon_{i,t} \) is an error term.

The results in Table 1 show that the returns are not normal and, for some currencies, the autocorrelation coefficients are greater than 0.10, therefore, we employ the Newey-West (1987) heteroskedasticity and autocorrelation consistent robust standard errors with 12 lags. The regression results are reported in Table 2.

We present the mean returns of the eight currencies of each month (from January to December) and their associated standard errors of their means in Table 2. We also report the mean and median returns, the number of (statistically significant) positive and negative returns of

**TABLE 2: Mean returns in different months**

<table>
<thead>
<tr>
<th>Currency Code</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
</tr>
</thead>
<tbody>
<tr>
<td>AU</td>
<td>-0.193</td>
<td>-0.103</td>
<td>-0.117</td>
<td>0.368</td>
<td>-0.165</td>
<td>-0.163</td>
<td>-0.162</td>
<td>-0.418</td>
<td>-0.050</td>
<td>-0.056</td>
<td>-0.143</td>
<td>0.810*</td>
</tr>
<tr>
<td></td>
<td>(0.421)</td>
<td>(0.615)</td>
<td>(0.483)</td>
<td>(0.447)</td>
<td>(0.517)</td>
<td>(0.339)</td>
<td>(0.497)</td>
<td>(0.398)</td>
<td>(0.638)</td>
<td>(0.618)</td>
<td>(0.596)</td>
<td>(0.474)</td>
</tr>
<tr>
<td>CN</td>
<td>-0.271</td>
<td>0.042</td>
<td>0.031</td>
<td>0.512</td>
<td>0.204</td>
<td>-0.119</td>
<td>-0.138</td>
<td>-0.089</td>
<td>0.418</td>
<td>-0.192</td>
<td>-0.406</td>
<td>0.050</td>
</tr>
<tr>
<td></td>
<td>(0.235)</td>
<td>(0.244)</td>
<td>(0.383)</td>
<td>(0.325)</td>
<td>(0.314)</td>
<td>(0.240)</td>
<td>(0.295)</td>
<td>(0.261)</td>
<td>(0.310)</td>
<td>(0.403)</td>
<td>(0.291)</td>
<td>(0.189)</td>
</tr>
<tr>
<td>EU</td>
<td>-1.809**</td>
<td>0.171</td>
<td>-0.287</td>
<td>-0.050</td>
<td>-0.449</td>
<td>-0.057</td>
<td>0.208</td>
<td>-0.245</td>
<td>0.847*</td>
<td>0.088</td>
<td>-0.150</td>
<td>1.267**</td>
</tr>
<tr>
<td></td>
<td>(0.456)</td>
<td>(0.458)</td>
<td>(0.537)</td>
<td>(0.397)</td>
<td>(0.467)</td>
<td>(0.437)</td>
<td>(0.482)</td>
<td>(0.354)</td>
<td>(0.442)</td>
<td>(0.510)</td>
<td>(0.500)</td>
<td>(0.452)</td>
</tr>
<tr>
<td>JP</td>
<td>-0.639</td>
<td>0.614</td>
<td>0.202</td>
<td>0.213</td>
<td>0.001</td>
<td>0.318</td>
<td>-0.015</td>
<td>0.476</td>
<td>0.806*</td>
<td>0.830</td>
<td>0.081</td>
<td>0.587</td>
</tr>
<tr>
<td></td>
<td>(0.427)</td>
<td>(0.564)</td>
<td>(0.644)</td>
<td>(0.453)</td>
<td>(0.498)</td>
<td>(0.465)</td>
<td>(0.504)</td>
<td>(0.480)</td>
<td>(0.414)</td>
<td>(0.640)</td>
<td>(0.622)</td>
<td>(0.550)</td>
</tr>
<tr>
<td>NZ</td>
<td>-0.367</td>
<td>0.199</td>
<td>-0.276</td>
<td>0.683*</td>
<td>-0.493</td>
<td>-0.194</td>
<td>-0.812</td>
<td>-0.815</td>
<td>0.220</td>
<td>0.066</td>
<td>0.229</td>
<td>0.473</td>
</tr>
<tr>
<td></td>
<td>(0.503)</td>
<td>(0.431)</td>
<td>(0.596)</td>
<td>(0.392)</td>
<td>(0.529)</td>
<td>(0.363)</td>
<td>(0.733)</td>
<td>(0.677)</td>
<td>(0.568)</td>
<td>(0.558)</td>
<td>(0.435)</td>
<td>(0.591)</td>
</tr>
<tr>
<td>SW</td>
<td>-1.547**</td>
<td>0.475</td>
<td>-0.140</td>
<td>-0.017</td>
<td>0.052</td>
<td>0.502</td>
<td>0.607</td>
<td>0.122</td>
<td>1.630**</td>
<td>0.221</td>
<td>0.042</td>
<td>1.733**</td>
</tr>
<tr>
<td></td>
<td>(0.535)</td>
<td>(0.612)</td>
<td>(0.607)</td>
<td>(0.510)</td>
<td>(0.469)</td>
<td>(0.525)</td>
<td>(0.559)</td>
<td>(0.435)</td>
<td>(0.467)</td>
<td>(0.581)</td>
<td>(0.631)</td>
<td>(0.600)</td>
</tr>
<tr>
<td>SE</td>
<td>-1.203**</td>
<td>-0.048</td>
<td>0.072</td>
<td>0.469</td>
<td>-0.304</td>
<td>-0.179</td>
<td>0.191</td>
<td>-0.621</td>
<td>0.813</td>
<td>-0.247</td>
<td>-0.709</td>
<td>0.933**</td>
</tr>
<tr>
<td></td>
<td>(0.436)</td>
<td>(0.478)</td>
<td>(0.467)</td>
<td>(0.411)</td>
<td>(0.473)</td>
<td>(0.439)</td>
<td>(0.512)</td>
<td>(0.403)</td>
<td>(0.541)</td>
<td>(0.672)</td>
<td>(0.621)</td>
<td>(0.408)</td>
</tr>
<tr>
<td>UK</td>
<td>-0.713*</td>
<td>-0.410</td>
<td>0.083</td>
<td>0.422</td>
<td>-0.293</td>
<td>0.326</td>
<td>0.516</td>
<td>-0.579*</td>
<td>-0.368</td>
<td>0.153</td>
<td>-0.331</td>
<td>0.595</td>
</tr>
<tr>
<td></td>
<td>(0.413)</td>
<td>(0.414)</td>
<td>(0.587)</td>
<td>(0.384)</td>
<td>(0.484)</td>
<td>(0.512)</td>
<td>(0.443)</td>
<td>(0.349)</td>
<td>(0.462)</td>
<td>(0.603)</td>
<td>(0.493)</td>
<td>(0.436)</td>
</tr>
</tbody>
</table>

Notes: The currency values are expressed as FC/US d, where FC is a foreign currency such as the Australian dollar. Mean returns and their associated standard errors of mean are expressed in percentages. Mean returns which are statistically significant different from zero at the 5% and 10% levels are denoted with ** and *, respectively. The samples are monthly, starting from January 1972 and ending in December 2010. +ve with (+ significant) and -ve (- significant) refers to the number of positive (statistically significant) and negative (statistically significant) returns, respectively.
the currencies in each month in the bottom four rows of Table 2. Table 2 clearly shows that December (January) has the highest (lowest) average and median returns, with eight out of eight currency returns reporting positive (negative) returns in December (January).

There are four currencies with statistically significant positive monthly returns in December (AU, EU, SW, SE) and four currencies (EU, SW, SE and UK) with statistically significant negative returns in January. Table 2 also shows that all eight currencies report a positive return in December and a subsequent negative return in January. If we take the Swiss franc as an example, on average, it appreciates against the USD by 1.733 per cent in December and then depreciates 1.547 per cent in January. For other months, some might display a certain return pattern (e.g. September) but no other seasonality is as significant as in December and January.

Second, we investigate whether the return of each month is statistically different from the average return of the other 11 months of the year. The regression model is specified as:

$$R_{i,t} = \alpha_{i,j} + \beta_{i,j}D_{j,t} + \varepsilon_{i,t}$$  \hspace{1cm} (3)

where $\alpha_{i,j}$ is an average return on the currency in the months other than month $j$, $\beta_{i,j}$ measures the difference of returns on month $j$ of currency $i$ from the returns on other months than month $j$. Table 3 reports the empirical results.

The statistics in Table 3 generally agree with the previous findings in Table 2. The average currency return in December is 0.323 percentage points higher than other months while January is 0.360 percentage points lower than other months. Among the eight currencies, there are five with a significant positive December effect (AU, EU, SW, SE, UK) and four (EU, SW, SE, JP) showing a significant negative January effect. As an example, the Swiss franc return in December is 1.556 percentage points higher than months other than December while its January return is 2.022 percentage points lower than months other than January. Table 3 also shows a September effect. Six currencies exhibit higher September returns than other months and half of them are statistically significant.

As a final test of robustness in these results, we conduct a joint test of monthly seasonality using the following system of equations:

<table>
<thead>
<tr>
<th>Currency Code</th>
<th>Jan - Non</th>
<th>Feb - Non</th>
<th>Mar - Non</th>
<th>Apr - Non</th>
<th>May - Non</th>
<th>Jun - Non</th>
<th>Jul - Non</th>
<th>Aug - Non</th>
<th>Sep - Non</th>
<th>Oct - Non</th>
<th>Nov - Non</th>
<th>Dec - Non</th>
</tr>
</thead>
<tbody>
<tr>
<td>AU</td>
<td>-0.175</td>
<td>-0.076</td>
<td>-0.092</td>
<td>0.437</td>
<td>-0.145</td>
<td>-0.142</td>
<td>-0.421</td>
<td>-0.019</td>
<td>-0.025</td>
<td>-0.121</td>
<td>0.920*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.467)</td>
<td>(0.612)</td>
<td>(0.495)</td>
<td>(0.548)</td>
<td>(0.540)</td>
<td>(0.380)</td>
<td>(0.537)</td>
<td>(0.421)</td>
<td>(0.629)</td>
<td>(0.620)</td>
<td>(0.618)</td>
<td></td>
</tr>
<tr>
<td>CN</td>
<td>-0.298</td>
<td>0.043</td>
<td>0.032</td>
<td>0.556</td>
<td>0.220</td>
<td>-0.131</td>
<td>-0.153</td>
<td>-0.099</td>
<td>0.455</td>
<td>-0.211</td>
<td>-0.445</td>
<td>0.031</td>
</tr>
<tr>
<td></td>
<td>(0.258)</td>
<td>(0.251)</td>
<td>(0.277)</td>
<td>(0.354)</td>
<td>(0.327)</td>
<td>(0.261)</td>
<td>(0.321)</td>
<td>(0.269)</td>
<td>(0.297)</td>
<td>(0.401)</td>
<td>(0.294)</td>
<td>(0.229)</td>
</tr>
<tr>
<td>EU</td>
<td>-1.932**</td>
<td>0.229</td>
<td>-0.271</td>
<td>-0.012</td>
<td>-0.448</td>
<td>-0.020</td>
<td>0.270</td>
<td>-0.225</td>
<td>0.967**</td>
<td>0.139</td>
<td>-0.121</td>
<td>1.424**</td>
</tr>
<tr>
<td></td>
<td>(0.428)</td>
<td>(0.465)</td>
<td>(0.576)</td>
<td>(0.382)</td>
<td>(0.515)</td>
<td>(0.417)</td>
<td>(0.479)</td>
<td>(0.398)</td>
<td>(0.452)</td>
<td>(0.527)</td>
<td>(0.519)</td>
<td>(0.460)</td>
</tr>
<tr>
<td>JP</td>
<td>-1.013**</td>
<td>0.354</td>
<td>-0.095</td>
<td>-0.083</td>
<td>-0.315</td>
<td>0.031</td>
<td>-0.322</td>
<td>0.203</td>
<td>0.564</td>
<td>0.590</td>
<td>-0.228</td>
<td>0.324</td>
</tr>
<tr>
<td></td>
<td>(0.418)</td>
<td>(0.602)</td>
<td>(0.653)</td>
<td>(0.492)</td>
<td>(0.562)</td>
<td>(0.447)</td>
<td>(0.505)</td>
<td>(0.505)</td>
<td>(0.400)</td>
<td>(0.654)</td>
<td>(0.672)</td>
<td>(0.566)</td>
</tr>
<tr>
<td>NZ</td>
<td>-0.302</td>
<td>0.316</td>
<td>-0.202</td>
<td>0.844**</td>
<td>-0.439</td>
<td>-0.113</td>
<td>-0.788</td>
<td>-0.790</td>
<td>0.339</td>
<td>0.171</td>
<td>0.348</td>
<td>0.615</td>
</tr>
<tr>
<td></td>
<td>(0.532)</td>
<td>(0.456)</td>
<td>(0.624)</td>
<td>(0.424)</td>
<td>(0.540)</td>
<td>(0.347)</td>
<td>(0.725)</td>
<td>(0.686)</td>
<td>(0.542)</td>
<td>(0.574)</td>
<td>(0.468)</td>
<td>(0.635)</td>
</tr>
<tr>
<td>SW</td>
<td>-2.022**</td>
<td>0.183</td>
<td>-0.487</td>
<td>-0.353</td>
<td>-0.278</td>
<td>0.213</td>
<td>0.328</td>
<td>-0.201</td>
<td>1.444**</td>
<td>-0.094</td>
<td>-0.289</td>
<td>1.556**</td>
</tr>
<tr>
<td></td>
<td>(0.504)</td>
<td>(0.594)</td>
<td>(0.663)</td>
<td>(0.531)</td>
<td>(0.528)</td>
<td>(0.512)</td>
<td>(0.552)</td>
<td>(0.483)</td>
<td>(0.488)</td>
<td>(0.625)</td>
<td>(0.677)</td>
<td>(0.612)</td>
</tr>
<tr>
<td>SE</td>
<td>-1.236**</td>
<td>0.024</td>
<td>0.154</td>
<td>0.588</td>
<td>-0.256</td>
<td>-0.119</td>
<td>0.284</td>
<td>-0.602</td>
<td>0.963*</td>
<td>-0.194</td>
<td>-0.697</td>
<td>1.093**</td>
</tr>
<tr>
<td></td>
<td>(0.448)</td>
<td>(0.472)</td>
<td>(0.529)</td>
<td>(0.440)</td>
<td>(0.438)</td>
<td>(0.453)</td>
<td>(0.552)</td>
<td>(0.455)</td>
<td>(0.513)</td>
<td>(0.647)</td>
<td>(0.625)</td>
<td>(0.421)</td>
</tr>
<tr>
<td>UK</td>
<td>-0.663</td>
<td>-0.333</td>
<td>0.204</td>
<td>0.574</td>
<td>-0.205</td>
<td>-0.242</td>
<td>0.674</td>
<td>-0.518</td>
<td>-0.287</td>
<td>0.281</td>
<td>-0.247</td>
<td>0.763*</td>
</tr>
<tr>
<td></td>
<td>(0.449)</td>
<td>(0.450)</td>
<td>(0.624)</td>
<td>(0.405)</td>
<td>(0.506)</td>
<td>(0.494)</td>
<td>(0.438)</td>
<td>(0.368)</td>
<td>(0.457)</td>
<td>(0.605)</td>
<td>(0.510)</td>
<td>(0.442)</td>
</tr>
</tbody>
</table>

# with +ve returns (# significant) 8 (0) 6 (0) 3 (0) 5 (1) 1 (0) 2 (0) 4 (0) 1 (0) 6 (3) 4 (0) 1 (0) 8 (5)
# with -ve returns (# significant) 0 (4) 2 (0) 5 (0) 3 (0) 7 (0) 6 (0) 4 (0) 7 (0) 2 (0) 4 (0) 7 (0) 0 (0)

Mean  -0.360  0.093  -0.095  0.244  -0.233  -0.065  0.018  -0.332  0.210  0.082  -0.225  0.323
Median -0.300  0.113  -0.094  0.437  -0.267  -0.116  0.065  -0.323  0.339  0.057  -0.238  0.324

Notes: The currency values are expressed as FC/US d, where FC is a foreign currency such as the Australian dollar. Mean returns and their associated standard errors of mean are expressed in percentages. Mean differences which are statistically significant different from zero at the 5% and 10% levels are denoted with ** and *, respectively. The samples are monthly, starting from January 1972 and ending in December 2010. ‘# with +ve’ denotes the number of with positive (statistically significant) and negative (statistically significant) returns, respectively.

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\[ R_{it} = \alpha_i + \beta D_{jt} + \varepsilon_{it}, \quad i = 1, \ldots, 8 \quad (4) \]

where \( i \) denotes a foreign currency ranging from the Australian dollar to the British pound. We simultaneously estimate eight equations. We constrain the slope coefficients (\( \beta \)) to be the same across all currencies for cross-sectional consistency, but allow the intercept \( \alpha_i \) to differ across the various currencies. We use the seemingly unrelated regression (SUR) method to estimate the system of equations. The SUR uses a weighted least-squares method that allows us to place constraints on the coefficients across these equations. We compute Newey and West (1987) standard errors for the parameter estimates in order to account for heteroskedasticity, autocorrelation and the contemporaneous cross-correlations in the errors from the different equations.

The results of the systems of equations are reported in Table 4. As the standard error of the beta coefficient for the Canadian dollar in the December dummy is far larger than the coefficient, to obtain a consistent result, we exclude the Canadian dollar from the SUR estimation. We also test whether the December–January effect has changed in the second half of the sample period. We add a dummy variable, \( D_{1996} \), which takes the value of 1 after 1996, and 0 otherwise. The results in Table 4 support the existence of the December–January effect. Taking Model [4] for example, the December return is significantly positive (0.673 per cent) while the average January return over the six currencies is significantly negative (-0.668 per cent). Interestingly, the results in Table 4 show that the two returns offset each other. In other words, the gain in December is offset by the subsequent loss in January. The dummy variable \( D_{1996} \) in Table 4 is statistically insignificant and therefore fails to find a significant structural change in 1996. Put simply, the December–January effect is persistent over the long-term and has not changed across the 1972–2010 sample period. Overall, these findings suggest that hedgers, arbitrageurs and speculators can benefit from (i) long foreign currency / short USD exposure in December and (ii) short foreign currency / long USD exposure in January, in the respective currencies outlined in this study.

As a final check of verification, we recalculate Tables 2 and 3 for a shorter 1985 to 2010 time period to remove any effect of major global currency adjustments from the former Bretton Woods and Smithsonian fixed rate regimes (1944–1973) to the current day floating rate and ‘dirty float’ regimes. The results of the shorter 1985–2010 data sample reveal the same findings with the exception of the Australian dollar which was found to remain positive and economically significant in December, but was statistically insignificant. All other statistically significant monthly returns remain persistent in the shorter 1985–2010 sample period. These additional tests are available on request from the authors. Overall, we can conclude that the December–January seasonality effect for these respective currencies remains persistent in today’s flexible exchange rate markets.

**TABLE 4: Joint tests of mean differences**

<table>
<thead>
<tr>
<th>Model</th>
<th>Coefficient</th>
<th>Std Error</th>
<th>( D_1 )</th>
<th>( D_9 )</th>
<th>( D_{12} )</th>
<th>( D_1 \cdot D_{1996} )</th>
<th>( D_{12} \cdot D_{1996} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>[1] ( \beta )</td>
<td>-0.715**</td>
<td>Std.Err (0.313)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[2] ( \beta )</td>
<td>0.141</td>
<td>Std.Err (0.343)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[3] ( \beta )</td>
<td>0.717**</td>
<td>Std.Err (0.343)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[4] ( \beta )</td>
<td>-0.668**</td>
<td>0.673*</td>
<td>Std.Err (0.313) (0.344)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[5] ( \beta )</td>
<td>-0.660*</td>
<td>-0.148</td>
<td>Std.Err (0.376) (0.653)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[6] ( \beta )</td>
<td>0.805**</td>
<td>-0.230</td>
<td>Std.Err (0.389) (0.685)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: \( D_1 \) is the January dummy, and \( D_{12} \) is the December dummy. \( D_{1996} \) is the dummy taking the value of 1 after 1996, and 0 otherwise. The system is estimated by SUR where seven currencies are in the systems (Canadian dollar is excluded). The currency values are expressed as FC/USD, where FC is a foreign currency such as the Australian dollar. The coefficients and their associated standard errors are expressed in percentages. Coefficients which are statistically significant different from zero at the 5% and 10% levels are denoted with ** and *, respectively. The samples are monthly, starting from January 1972 and ending in December 2010.
Conclusion
The findings from this study shine new light on the monthly seasonality of FX returns. Three tests of monthly seasonality were estimated on the returns of eight major currencies (against US dollar) from January 1972 to December 2010. We show that a number of currencies exhibit significantly higher returns in December than in other months. Interestingly, the higher returns of these foreign currencies are reversed with significant negative returns in January. The evidence presented in this paper provides important information to market participants including hedgers, arbitrageurs and speculators. Industry professionals interested in these calendar effects may seek to identify the source of this FX seasonality in the months of December and January. Important indicators such as terms of trade statistics, monthly capital flows with the United States or other economic/financial statistics may provide new information in better understanding the dynamics of this seasonality effect. We leave this future empirical work for others.

References

Industry professionals interested in these calendar effects may seek to identify the source of this FX seasonality in the months of December and January. Important indicators such as terms of trade statistics, monthly capital flows with the United States or other economic/financial statistics may provide new information in better understanding the dynamics of this seasonality effect.
This research study examines the sustainability disclosures of the three Australian banks which prepared their sustainability reports in compliance with the Global Reporting Initiative’s (GRI) G3 Sustainability Reporting Guidelines and Financial Services Sector Supplement. This initiative became obligatory on 1 January 2010 for organisations that wish to achieve the highest level of disclosure. The results indicate that although the three banks achieved the highest level of disclosure, there were several areas that needed improvement.

In the 1970s, there was much discussion about the impact of economic development on the environment. A significant development of the notion of sustainability occurred with the definition of sustainable development in the *The Brundtland Report* that was presented by Gro Harlem Brundtland — the then Prime Minister of Norway and Chairman of the World Commission of Environment and Development — to the General Assembly of the United Nations in 1987. In the report, sustainable development is defined as ‘development that meets the needs of the present world without compromising the ability of future generations to meet their own needs’.

There is scientific evidence that economic development has had a negative impact on the earth. For example, the Intergovernmental Panel on Climate Change (2001) states in its report entitled *Climate Change 2001: Working Group I: the Scientific Basis* that, ‘An increasing body of observations gives a collective picture of a warming world and other changes in the climate system ... There is new and stronger evidence that most of the warming observed over the last 50 years is attributable to human activities’.

Today, many organisations, industry associations, professional bodies, governments and non-government organisations have come to accept the notion of sustainability in economic development. It is now widely accepted that sustainability comprises three dimensions, namely, economic, environmental and social. This is commonly known as the triple bottom line model (Elkington 1997). An organisation is said to be sustainable if it performs well on economic (financial) performance, environmental performance and social performance. Triple bottom line reporting or sustainability reporting enables stakeholders of organisations to assess the sustainability performance of organisations.

Corporate sustainability reporting is undertaken on a voluntary basis in most countries. However, an increasing number of companies worldwide are engaging in sustainability reporting, especially large multinationals. According to the KPMG (2008) international survey of corporate responsibility reporting, approximately 80 per cent of the top 250 companies listed on the Fortune Global 500 (G250) prepared sustainability reports compared with around 50 per cent in the 2005 survey. The top three drivers for reporting were ethical considerations, economic considerations and reputation or brand.

In Australia, the KPMG (2008) survey found that 68 per cent of the largest 100 companies listed on the Australian Stock Exchange (ASX) provided sustainability performance information — a more than double increase from 2005. The key drivers for reporting were the *National Greenhouse and Energy Reporting Act 2007*, the development of the Department of Climate Change’s Carbon Pollution Reduction Scheme (CPRS) and the ASX’s revised Principle 7, which now considers sustainability issues as a material business risk.
The KPMG (2008) survey also found that the majority of companies surveyed used the Global Reporting Initiative’s Sustainability Reporting Guidelines (GRI guidelines) to prepare their sustainability reports. More specifically, more than 75 per cent of the G250 companies and about 70 per cent of the 100 largest companies by revenue from 22 countries (N100) used the GRI guidelines. The Global Reporting Initiative (GRI) was established in 1997. It was convened by the Coalition for Environmentally Responsible Economies in the United States and the United Nations Environment Programme. Today, the GRI collaborates with 20,000 stakeholders from 80 countries to advance sustainability reporting. These stakeholders include the following organisations: Association of Chartered Certified Accountants, Canadian Institute of Chartered Accountants, Council of Economic Priorities, Institute of Social and Ethical Accountability, Tellus Institute, World Business Council for Sustainable Development and World Resources Institute. According to GRI (2006), sustainability reports that are prepared based on the GRI guidelines can be used for ‘benchmarking and assessing sustainability performance with respect to laws, norms, codes, performance standards and voluntary initiatives; demonstrating how the organisation influences and is influenced by expectations about sustainable development; and comparing performance within an organization and between different organizations over time’ (p. 3). Although it is helpful to use the GRI guidelines, they are not without limitations. As Sustainability Ltd and United Nations Environment Programme (2002) noted:

> Although it is helpful to use the GRI guidelines, they are not without limitations.

The GRI Guidelines themselves allow companies partially off the hook. A company can be GRI compliant whilst looking at the least impactful aspect of their business. Consider the case of McDonald’s whose inaugural GRI-based report, released earlier in 2002, makes only passing mention of agriculture issues, where an enormous proportion of McDonald’s impact lies … Alan Willis, one former GRI Steering Committee member and Verification Working Group participant urges: ‘GRI needs to be increasingly vigilant of company abuse of the guidelines or process — claiming their reporting is ‘In Accordance’ when it’s not; incomplete, inaccurate, misleading or inappropriate’ (p. 17).

Despite the limitations of the GRI guidelines, they have been used in research studies on corporate sustainability reporting (see, for example, Frost et al. 2005; Jones et al. 2007). As explained by Frost et al. (2005), ‘there will always be potential problems with the adoption of a generic set of reporting guidelines given the diversity of the issues covered and the complex nature of corporations’ (p. 90).

The first version of the GRI guidelines was issued in 2000. It was revised and the second version — commonly referred to as the G2 — was issued in 2002. The latest version — the G3 — was issued in 2006. The GRI G3 guidelines require organisations to make Standard Disclosures in their sustainability reports. These disclosures comprise of Strategy and Profile, Management Approach and Performance Indicators and they are defined as follows:

- **Strategy and Profile**: Disclosures that set the overall context for understanding organizational performance such as its strategy, profile, and governance.
- **Management Approach**: Disclosures that cover how an organization addresses a given set of topics in order to provide context for understanding performance in a specific area.
- **Performance Indicators**: that elicit comparable information on the economic, environmental, and social performance of the organization’ (p. 5).

The Strategy and Profile comprises of two disclosures on Strategy and Analysis, 10 disclosures on Organizational Profile, 13 disclosures on Report Parameters and 17 disclosures on Governance, Commitments, and Engagement. The Management Approach contains disclosures on six topics, namely, economic, environmental, labor practices and decent work, human rights, society and product responsibility. The Performance Indicators are grouped into three categories: economic, environmental and social. There are nine economic performance indicators, 30 environmental performance indicators and 40 social performance indicators.

The GRI has also developed Sector Supplements that are applicable to organisations in specific sectors. These supplements are developed to address sustainability reporting issues that are unique to specific sectors. Each sector supplement has its own management approach and performance indicators. Currently, GRI has finalised the following sector supplements: Electric Utilities, Financial Services, Food Processing, Mining & Metals and
Corporate environmental disclosures have increased over time. These disclosures are predominantly ‘positive’. Big companies tend to disclose more environmental performance information compared with small companies.

Non-Government Organizations. The Financial Services Sector Supplement was first issued in October 2008. The GRI has made it obligatory from 1 January 2010 for organisations in the financial services sector to report on all the performance indicators in the supplement if they wish to achieve Application Level A — the highest level of disclosure out of three application levels (the other two being Level B and Level C, where Level C represents the minimum level of disclosure). The Financial Services Sector Supplement has one management approach disclosure and 16 performance indicators (financial services performance indicators).

Literature review

Research studies on corporate sustainability disclosures in Australia have so far examined mainly environmental disclosures (for example, Deegan and Gordon 1996; Deegan and Rankin 1996; Wilmhurst and Frost (2000) and Deegan et al. (2002). A few research studies have extended the examination to social disclosures (for example, Guthrie and Parker 1989). Recently, Frost et al. (2005) examined corporate sustainability disclosures in various reporting media: annual reports, sustainability reports and websites. The major findings of these research studies are as follows. Corporate environmental disclosures have increased over time. These disclosures are predominantly ‘positive’. Big companies tend to disclose more environmental performance information compared with small companies. Moreover, companies in environmentally sensitive industries are more likely to disclose more environmental performance information compared with companies in less environmentally sensitive industries. The environmental disclosures of companies are overwhelmingly ‘self-laudatory’. Corporate sustainability reports were found to contain the bulk of sustainability disclosures followed by websites and annual reports.

This research study builds on extant literature by examining the sustainability disclosures of banks in Australia, by using the GRI (2006) G3 guidelines and the GRI (2008) financial services sector supplement. The findings of this study will contribute to our understanding of sustainability disclosures of banks in Australia and to identify areas for improvement.

Research methodology

The study of the sustainability disclosures of banks in Australia commenced with the selection of the banks to be examined. As at 25 July 2011, there were only three banks in Australia that prepared sustainability reports which complied with the GRI G3 guidelines. They were ANZ Banking Group (ANZ), National Australia Bank (NAB) and The Westpac Group (Westpac). The 2010 sustainability reports of these banks together with their GRI Content Indices were downloaded from the banks’ websites and examined. All of the sustainability reports and GRI Content Indices were externally assured and, therefore, can be relied upon.

The GRI Content Index is a table that lists all of the Standard Disclosures, sector supplement performance indicators and the organisation’s comments on the disclosures and indicators. The index provides report users with a quick overview of the organisation’s sustainability disclosures. A score of 0 or 1 is given for the absence or presence of a disclosure and performance indicator. The quality of the disclosure and performance indicator is not evaluated. This method of scoring is consistent with Frost et al. (2005) who, as mentioned earlier, examined sustainability disclosures in various reporting media.

Results and discussion

All of the banks’ sustainability reports are Application Level A reports. As explained earlier, Application Level A indicates the highest level of disclosure. Detailed results of the sustainability disclosures of the banks are shown in Table 1. The results show that all three banks provided all of the disclosures in the Strategy and Profile and Management Approaches, which is commendable. In relation to the disclosure on performance indicators, Westpac provided disclosures on all of the 95 indicators, ANZ provided disclosures on 84 indicators and NAB provided disclosures on 64 indicators.

Table 2 shows the reasons that the banks provided for the omission of certain performance indicators. ANZ did not provide disclosure on a total of 11 indicators. Seven of these indicators were not disclosed because they were not applicable to their business. NAB omitted a total of 31 indicators. Six of these indicators were omitted because they were not material to the bank. The other four indicators were omitted because they were not applicable. No reason was given for the omission of the other 25 indicators. It is recommended that if an indicator is omitted, a reason for omission should be given to help report readers understand why it was not disclosed.

Another area that could be improved relates to the comments made by the banks on each performance indicator. There are material numbers of comments that are not performance indicator-specific. Examples of these comments are shown in Table 3. The table shows that banks inform report readers where the comments on the performance indicator can be found by providing the web links, page numbers and specific web address (URL). These are useful to the report readers. However, when report readers go to these locations, they are not entirely clear which part(s) of the discussion relates specifically to the performance indicator. It is recommended that banks
TABLE 1: Sustainability disclosures of banks

<table>
<thead>
<tr>
<th>Disclosure / Indicator</th>
<th>Maximum Disclosure</th>
<th>ANZ</th>
<th>NAB</th>
<th>WESTPAC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategy and Profile</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategy and Analysis</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Organisation Profile</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Report Parameters</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Governance, Commitments, and Engagement</td>
<td>17</td>
<td>17</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>42</td>
<td>42</td>
<td>42</td>
<td>42</td>
</tr>
<tr>
<td><strong>Management Approach</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td><strong>Performance Indicators</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic</td>
<td>9</td>
<td>9</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Environmental</td>
<td>30</td>
<td>20</td>
<td>17</td>
<td>30</td>
</tr>
<tr>
<td>Social</td>
<td>40</td>
<td>39</td>
<td>25</td>
<td>40</td>
</tr>
<tr>
<td>Financial Services</td>
<td>16</td>
<td>16</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>95</td>
<td>84</td>
<td>64</td>
<td>95</td>
</tr>
</tbody>
</table>

TABLE 2: Reasons for omission of performance indicators (PIs)

<table>
<thead>
<tr>
<th>Reason</th>
<th>ANZ (Number of PIs)</th>
<th>NAB (Number of PIs)</th>
<th>WESTPAC (Number of PIs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not material</td>
<td>7</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Not applicable</td>
<td>4</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>No reason given</td>
<td>-</td>
<td>25</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>11</td>
<td>31</td>
<td>-</td>
</tr>
</tbody>
</table>

TABLE 3: Examples of unspecific bank comments

<table>
<thead>
<tr>
<th>Bank and Performance Indicator</th>
<th>Description of indicator</th>
<th>Comments / Location of comments</th>
</tr>
</thead>
</table>
| ANZ - FS6                      | Percentage of the portfolio for business lines by specific region, size (e.g. micro/SME/large) and by sector | • Our business structure  
• Our company profile  
• Our countries of operation  
• About our customers  
• Our approach to sensitive sector lending  
• Our approach to project financing  
• ANZ’s segment analysis (pp. 173-174)  
• ANZ acquisitions |
| NAB - FS1                      | Policies with specific environmental and social components applied to business lines. | AR: Community (pp. 28-29), Environment (pp. 30-31), Supply Chain (p. 31)  
DDCM: Dig Deeper Community  
DDE: Dig Deeper Environment  
DDSC: Dig Deeper Supply Chain  
WEB: http://www.nabgroup.com/0._91282.00.html |
| WESTPAC - FS16                 | Initiatives to enhance financial literacy by type of beneficiary | WRBB, Westpac New Zealand, Pacific Banking  
Financial capability (Westpac Australia)  
Indigenous  
Managing your Money (NZ) |

clearly indicate in the location(s) where the report readers are directed to, which part(s) of the discussion relates specifically to the performance indicator.

The other area requiring improvement relates to the extent to which each performance indicator is disclosed. ANZ and NAB indicated whether each indicator was ‘fully’, ‘partially’ or ‘not reported.’ Westpac did not do so. However, they did provide comments for every indicator. It is recommended that banks inform report users whether they have reported fully, partially or not reported on every indicator so that report users know to what extent each indicator has been disclosed.
Conclusion
This research study examines the sustainability disclosures of banks in Australia by using the GRI G3 guidelines and the GRI financial services sector supplement. The results show that, although the sustainability reports of ANZ, NAB and Westpac are Application Level A reports, there are several areas that need to be improved. First, banks should provide the reason for omission of every performance indicator that is omitted from disclosure. Second, banks should clearly indicate which part(s) of the discussion relate specifically to the performance indicator at every location that the report users are directed to. Third, banks should indicate whether they have fully reported, partially or not reported on every performance indicator.

Future research studies could examine sustainability disclosures in other financial services sub-sectors such as securities and finance sub-sectors in order to gain an understanding of sustainability disclosures in these sub-sectors and to identify areas for improvement.

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Department of Climate Change 2008, Carbon pollution reduction scheme: Australia’s low pollution future, Canberra.
Global Reporting Initiative 2006, Sustainability reporting guidelines (G3) [Online]. Available at www.globalreporting.org [2011, July 25].
Intergovernmental Panel on Climate Change 2001, Climate change 2001: Working Group I: the scientific basis, United Nations.
National Greenhouse and Energy Reporting Act 2007 (no. 175, 2007).
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Managing Director, Head of Corporate Banking,
Country Manager Bank of America N.A. Sydney Branch

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Finsia acknowledges the contribution of the papers from the 16th Melbourne Money and Finance Conference to this issue of JASSA. Additional papers will be included in JASSA issue 4, 2011. The conference — Retail and Household Finance: Current Issues — was held in July 2011 by the Australian Centre for Financial Studies.

We gratefully acknowledge the support of the generous sponsors:
ANZ, APRA, Finsia — The Financial Services Institute of Australasia, NAB, Reserve Bank of Australia
The following section in this issue of JASSA is devoted to papers from the 16th Melbourne Money and Finance Conference. The conference — Retail and Household Finance: Current Issues — was conducted by the Australian Centre for Financial Studies and held in Melbourne in July 2011. The sponsors of the conference were the ANZ Bank, Australian Prudential Regulation Authority (APRA), Finsia, National Australia Bank and the Reserve Bank of Australia.

The conference papers selected for this issue of the journal focus on a range of important superannuation and taxation issues, highlighting key areas where further reform may be necessary, both within Australasia and internationally.

The first paper, by Tom Valentine, examines the rapid growth in self-managed superannuation funds in recent years to become the largest single component of the superannuation industry. Because the growth in SMSFs has been fostered by significant tax concessions, he questions whether this arrangement generates sufficient benefits to justify these concessions or whether it is simply a tax avoidance scheme for the wealthy, as some commentators have argued.

Next, we turn to the phenomenal growth in ethical and responsible investment markets, despite the global financial crisis. Howard Pender and Marie Brocchetto provide an overview of the framework for, and key issues involved in, ethical investing at the retail level in Australia. They indicate that this primarily involves screened portfolios, with limited activity occurring in community finance and shareholder advocacy.

Kevin Davis SF Fin, Ross Higgins and Deborah Ralston SF Fin examine the rationale for government policies aimed at influencing household savings and investment decisions — focusing on the financing of life-cycle events and the design of suitable financial products to achieve desired outcomes. They note the context for these policies, which includes the difficulties facing individuals in developing and executing optimal lifetime savings and investment plans, growing product complexity and the increasing demands on government to support individuals’ financial needs.

The paper by Gordon D. Mackenzie F Fin indicates that while tax distortions are traditionally measured using marginal tax rates, or real effective tax rates (Henry Review Panel), empirical studies have identified six margins where tax affects investment decisions. He suggests that measuring selected Australian savings vehicles against those margins highlights tax distortions affecting retail investor behaviour, and that these findings have significance for tax policy makers and financial institutions, as well as the current policy debate about the standards of tax knowledge mandated for financial planners.

Ross Clare examines the key challenges in developing a post-retirement superannuation policy and provides potential policy options to address them. He observes that much of the recent focus on superannuation policy outcomes and settings has related to the accumulation phase, and considerable work remains to be done regarding the post-retirement phase. And, although the Henry and Cooper reports raised a number of important post-retirement issues, their recommendations provided only a partial response to the challenges involved.

I would like to thank both the sponsors of the conference and the authors for their contribution to this issue of JASSA. The next issue of the journal will include the remaining papers from the conference which generally have a banking, investor protection and regulatory theme.
Self-managed superannuation funds (SMSFs), also called DIY superannuation funds, are larger than any other single component of the superannuation industry. Their growth has been fostered by the significant tax concessions which they share with other superannuation vehicles. It is, therefore, legitimate to ask whether this arrangement generates benefits sufficient to justify the concessions or whether, as some commentators argue, it is simply a tax avoidance scheme for the wealthy.

This paper examines the growth of SMSFs and the reasons why this particular form of superannuation fund is attractive to savers. The paper also considers whether the encouragement of saving is a desirable objective for an Australian government and it examines the performance of SMSFs within this context.

The encouragement of SMSFs would be an undesirable policy if it resulted in saving being directed into underperforming assets. This paper also addresses prudential problems in the SMSF sector, possible reforms in this area, and the implications of the restrictions on borrowing by superannuation funds.

SMSFs

In order to qualify as an SMSF, a fund must have fewer than five members who are linked in some way, all of whom are trustees (either directly or indirectly via company trustee structure), and who receive no remuneration for acting as a trustee. The members of a fund are those who are accumulating benefits in it or receiving a pension from it. Members are linked if they are related or are business partners in the sense of being directors of the same company, trustees of the same trust or partners in a business.

SMSFs are subject to two tests — the sole purpose test and the in-house assets test. The purpose of these tests is to ensure that the fund is not used for personal consumption purposes. The sole purpose test (see Colley 2010, pp. 335–336) requires that the fund be used solely for the provision of benefits in retirement (or after age 65 or upon death of the member). The in-house assets test requires that the fund hold no more than 5 per cent of the market value of its assets in in-house assets. These are assets which are directly or indirectly linked to a member of the fund (see Colley 2010, pp. 336–340).

The current environment for SMSFs was established with the introduction of the Superannuation Industry (Supervision) Act 1993. This environment gives the following specific advantages to SMSFs (or DIY funds):

> They allow members to control their own investments. Many people find this attractive because they believe that they can earn a higher return than professional managers.

An earlier version of this paper was presented to the 16th Melbourne Money and Finance Conference — Retail and Household Finance: Current Issues. The conference was held in July 2011 by the Australian Centre for Financial Studies.

An Australian Stock Exchange (2003) report cites this as a motive for adopting a SMSF. A survey carried out by the Cooper Review (Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System) produced the same result. The second and third motivations (well behind the first) were ‘greater flexibility over investment options’ and ‘believe SMSF can perform better than previous superfund’. 
SMSFs do not attract the fees charged by professionally managed superannuation funds (although there are costs in administering SMSFs).

SMSFs provide members with considerable flexibility. For example, members can withdraw funds in the case of illness.

SMSFs also share the advantages available to all superannuation funds of significant taxation advantages for savings. Contributions are taxed at 15 per cent, income of the fund is taxed at 15 per cent (10 per cent for capital gains), and final benefits can be withdrawn on favourable terms. In addition, life insurance premia paid through funds are tax deductible, and superannuation assets are protected from creditors in bankruptcy actions.

Members can make undeducted in specie contributions to a superannuation fund by contributing existing assets. However, only certain assets can be contributed in this way and must be transferred at market value.

The disadvantages of SMSFs include:

- SMSFs are only cost effective for investors with significant assets. Estimates of the minimum asset level required vary, but they are in the order of $200,000.
- Administration of SMSFs can be complex. The Australian Taxation Office sets detailed compliance responsibilities for these funds.
- The trustees of these funds are generally inexperienced in making investment decisions and may produce poor returns. The Australian Stock Exchange (2003, p. 27) notes that managers of SMSFs ‘tend to stick with investments they know/understand’. This problem is relevant to the public policy objective of allowing these funds to facilitate the accumulation of adequate retirement resources by large numbers of individuals and families. Also, there is a risk that inexperienced or time-poor managers may allow their fund to become non-compliant.
- SMSFs cannot use the Superannuation Complaints Tribunal and members are not eligible for compensation for losses arising from fraud.
- The trustees of an SMSF could be personally liable for members’ losses.
- Apart from special cases, money in a superannuation fund cannot be accessed until retirement and there is a common view that it is exposed to future arbitrary changes in government policy, especially taxation policy.

Table 1: Assets of superannuation funds, March 2010

<table>
<thead>
<tr>
<th>Category</th>
<th>$billion</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate</td>
<td>60.9</td>
<td>171</td>
</tr>
<tr>
<td>Industry</td>
<td>226.6</td>
<td>65</td>
</tr>
<tr>
<td>Public sector</td>
<td>177.4</td>
<td>39</td>
</tr>
<tr>
<td>Retail</td>
<td>351.2</td>
<td>154</td>
</tr>
<tr>
<td></td>
<td>816.0</td>
<td>429</td>
</tr>
<tr>
<td>Small APRA Funds</td>
<td>1.6</td>
<td>3879</td>
</tr>
<tr>
<td>Single Member ADFs</td>
<td>0.0</td>
<td>105</td>
</tr>
<tr>
<td>Self-managed super funds</td>
<td>400.2</td>
<td>422687</td>
</tr>
<tr>
<td>Balance of life office statutory funds</td>
<td>39.6</td>
<td>1257.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>427179</td>
</tr>
</tbody>
</table>


Table 1 shows the results of these incentives/disincentives. SMSFs are the largest category of superannuation funds and hold around 32 per cent of superannuation assets.

Saving policy

Governments led by both of the major political parties have adopted policies aimed at stimulating saving. This objective has been criticised as irrelevant and as favouring the wealthy. However, there are good reasons for encouraging saving. These are outlined below.

- Until 2008, the household saving ratio was close to zero, perhaps negative. It is true that this ratio has increased in recent years, but we are likely to revert to earlier behaviour once the memory of the global financial crisis fades.
- Saving is the change in national wealth. If it is low, we are not adding to national wealth, which will reduce national income in the future.
- Any deficiency in the domestic supply of funds will have to be covered by importing funds through running a current account deficit. This inflow of funds will, other things being equal, cause an appreciation of the Australian dollar, which damages businesses in the ‘slow-speed’ section of the economy (i.e. non-mining industries).
- With an ageing Australian population, there is an emerging problem of providing an income for the increasing percentage of retirees in the population. If this is not done, future taxpayers will carry an increasing burden.
The second and third points can be elucidated by examining the twin deficits relationship which is:

\[ \text{CAD} = (I - S) + DF \]

where,
- CAD = current account deficit
- I = investment
- S = private (household and business) saving
- DF = government budget deficit (government dissaving)

This identity indicates that the CAD covers the shortfall of saving within Australia. Also, we can rewrite the identity as:

\[ S - DF = I - CAD \]

i.e. total saving (the change in wealth) is equal to investment minus the current account deficit.

The only policies which appear to be useful in increasing saving are to:

> allow governments to save for us by running surpluses and transferring them to entities such as the Future Fund. This approach faces political obstacles; or
> increase contributions under the Superannuation Guarantee Change, which also faces political problems; or
> make contributions to superannuation attractive. The encouragement of SMSFs is an effective way to do this.

It is true that the second and third approaches favour higher-income taxpayers. However, if the aim is to encourage saving (rather than to redistribute income), this bias cannot be avoided.

Performance of SMSFs

An obvious concern about SMSFs is that they may adopt a suboptimal investment policy because of the lack of knowledge or preferences of the trustee. Table 2 indicates the composition of the assets of all superannuation funds and those of SMSFs.

SMSFs hold a higher percentage of cash, property and shares than superannuation funds as a whole. However, they hold less in securities and (especially) overseas assets. These large cash holdings could be a problem for long-term wealth accumulation because it is typically a safe but low yielding asset.

One way of evaluating these portfolios is to compare them to the Markowitz efficient frontier for Australian asset classes shown in Figure 1. The asset classes included are cash, Australian and international fixed interest, Australian and international shares and property, and the data were obtained from the AXA website.

The minimum variance portfolio has an average return of 9.62 per cent p.a. and a standard deviation of 4.79 per cent p.a. It includes cash (85.6 per cent), Australian fixed interest (10.2 per cent) and Australian shares (4.0 per cent). As might be expected, this is a very conservative portfolio. As you move up the efficient frontier, the percentages of Australian shares and Australian fixed interest increase, and the percentage of cash falls. For example, a portfolio close to the middle of the efficient frontier with an average return of 11.94 per cent p.a. and a standard deviation of 10.1 per cent includes: Australian fixed interest (43.4 per cent); international fixed interest (14.2 per cent); Australian shares (30.2 per cent); and property (12.2 per cent). Of course, the highest portfolio contains only the highest yielding asset class over the period of the study (i.e. Australian shares).

The results give rise to a number of comments. First, cash is a very attractive asset over this period because it has a high average return (bolstered by very high returns on cash in the early part of the period) and a low standard deviation of returns. The return on cash also has low correlations with the returns on other asset classes.

Second, no international shares are included in the portfolios on the efficient frontier and they include

<table>
<thead>
<tr>
<th>All Superannuation Funds (June 2010)</th>
<th>SMSFs (June 2010)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>Percentage</td>
</tr>
<tr>
<td>Cash and deposits</td>
<td>16.5</td>
</tr>
<tr>
<td>Loans and placements</td>
<td>1.0</td>
</tr>
<tr>
<td>Short-term securities</td>
<td>5.6</td>
</tr>
<tr>
<td>Long-term securities</td>
<td>5.4</td>
</tr>
<tr>
<td>Equities and units in trusts</td>
<td>44.4</td>
</tr>
<tr>
<td>Land and buildings</td>
<td>7.0</td>
</tr>
<tr>
<td>Assets overseas</td>
<td>16.7</td>
</tr>
<tr>
<td>Other assets</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Source: Statistical tables, Reserve Bank of Australia and ATO websites.
relatively little international fixed interest. This result leads to a rejection of the assertion that Australian investors suffer adversely from ‘home bias’. Our calculations indicate that rational Australian investors would not have included international shares in their portfolios over the 1981–2009 period.

It is also worth noting that if we take the international share return as the market return, the software estimates the beta for Australian shares as 0.688. This value is similar to those obtained by Valentine (2006) and it indicates that Australian shares are less risky than overseas shares.

It appears that neither of the portfolios given in Table 2 would be on the efficient frontier. In particular, both of them include an excessive amount of cash (i.e. are very conservative) and an insufficient amount of fixed interest securities. However, the low representation of overseas assets in the portfolios of SMSFs actually represents an optimal decision.

In financial years 2006, 2007 and 2008, SMSFs achieved returns on assets (ROAs) of 12.6 per cent, 16.9 per cent and -6.1 per cent, respectively. In the corresponding years, the ROAs for APRA superannuation funds were 23.9 per cent, 28.7 per cent and -13.4 per cent. That is, SMSFs have underperformed other superannuation funds. Moreover, many SMSFs are quite small and smaller funds achieved a lower ROA than larger funds. This outcome could be due, in part, to the poor diversification of these funds. As at 30 June 2008, about 53 per cent of SMSFs with a fund size of $50,000 or less invested in only one asset class and held 77 per cent of their assets in listed shares and cash.

It should be noted that both groups underperformed the S&P/ASX 200 Accumulation Index in the 10 years from 2000 to 2009. This raises the question of the time horizon over which investment performance should be measured.

Comments about the relative variability of the returns on different assets are often based on short time periods (e.g. one quarter or one year). Such measures are useful if we are investing for one year, but if the time horizon is longer, we should use a measure appropriate for that longer period. If we are investing for 10 years, the relevant variability measure is the 10-year variability of returns. Thus, share returns are quite variable on a year-to-year basis, but if we look at 10-year returns, the variability is much lower. Shares may be a risky short-term investment, but a much safer long-term investment. Figure 2 shows the one-year and 10-year percentage changes in the All Ordinaries Share Price Index over the period from 1950 to 2010. It is clear that the one-year change is much more volatile than the 10-year change. In particular, there are 23 one-year negative changes in this 60-year period, whereas there was only one 10-year period which produced a negative change over the whole period.

Let us consider the desirability of diversification when the investor has a long time horizon. This is certainly the case when we are considering superannuation funds which may evolve into pensions. There is no disagreement about the desirability of diversifying within asset classes (such as cash, domestic and international fixed interest, domestic and international shares, and property). Investors should not hold a single asset or a very small number of assets in their portfolios.

Figure 2 illustrates that as the time horizon increases, the variability of returns falls, and it is also the case that the correlations of returns across asset classes increase. In terms of the Markowitz model, this means that investors (other than those who are extremely risk averse) should put 100 per cent of their funds into the highest yielding asset class. Over the past 20 years, this would mean property or Australian shares, which produced similar returns when we consider franking credits on shares. This view has been supported by a number of commentators. Malkiel (2005, p. 88) concludes that ‘... stocks are a wholly appropriate medium for investing in long-term retirement funds’. He expands this point further as follows (see pp. 89–90):

One rule of thumb used by some investment advisers is to set the proportion of bonds in your portfolio equal to your age. A woman in her twenties should keep only 20 per cent of her portfolio in relatively safe bonds and...
80 per cent in equities. A man aged seventy five should put no more than 25 per cent of his portfolio in stocks, and that equity exposure should probably contain a substantial proportion of real estate investment trusts with their generous dividend yields that can be used for living expenses.

Clare (2005, p. 4) makes the same point in a different way.

One study suggests that over the last 100 years shares have returned about 11 per cent a year compared to a mere 4 per cent from bank deposits and the like, implying a premium return to shares of around 7 per cent a year in order to compensate for the volatility of returns.

... Looking at these numbers the real mystery might be why superannuation funds invest in anything other than growth assets.

These considerations indicate that the commonly accepted Australian view that a high degree of diversification is desirable in investors’ portfolios is incorrect. In a large number of cases, we may be giving investors bad advice.

Possible changes

Our discussion indicates that the existence of SMSFs encourages saving and there appear to be few alternative ways to accomplish this objective. However, these funds, in common with other superannuation funds, do not appear to be achieving their potential in earning returns and, therefore, in accumulating resources to fund retirements. Some changes may reduce these problems.

First, as suggested by Valentine (2004), SMSFs could be required to choose their portfolios from a small number of indexed portfolios suggested by the regulator. These portfolios should be heavily focused on the highest yielding assets — shares and property — so as to ensure the highest possible average return over the long accumulation period. However, given that the ability to choose assets is one of the attractions of SMSFs, this may reduce contributions to them. Perhaps contributors could be given flexibility with respect to a small proportion of the portfolio. The alternative is to carry out an education program to develop a longer-term approach to investment. Such a program would need to start with regulators, accountants and financial advisers.

Second, any education program should stress the undesirability of creating small SMSFs which are not likely to grow. Again, the primary target should be advisers.

Third, there is a restriction on superannuation borrowing. This restriction makes superannuation funds less attractive than non-super portfolios which can gear their assets. Of course, superannuation funds have numerous ways of obtaining leverage so long as it is not called a loan. These include high beta shares or share funds, leveraged share funds, hedge funds, instalment warrants on shares and (recently) property and positions in derivatives. The problem with these approaches is that the degree of leverage can be difficult to measure and trustees can easily be led into taking excessive risks. Property purchases could be a particular problem. A relatively small fund would only be able to purchase a single investment property and this would produce a very undiversified portfolio. A better alternative would be to allow superannuation funds to take a loan secured on the assets of the fund from a financial institution up to a certain (modest) percentage of the value of the assets of the fund. This opportunity would make SMSFs more attractive.

It is reasonable to ask whether SMSFs should be prohibited from holding derivative products because they are so highly geared. It might be objected that such a restriction would prevent funds from using these instruments to hedge their asset values. For example, they would not be able to sell index futures or buy put options to hedge share portfolios. However, when we take account of the very long investment horizon appropriate for a SMSF, it is not clear why such hedging would be necessary.

Fourth, the Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System (the Cooper Review) made a number of recommendations with respect to SMSFs. They are summarised by Colley (2010, pp. 363–364) and include:

> a review of borrowing restrictions with a view to tightening them. A better approach was proposed above;
> in-house investments should not be allowed;
> advisers should be required to have an AFSL to advise on the setting up of an SMSF; and
> SMSFs should be required to add value their assets at net market value.

There were also some recommendations aimed at preventing specific abuses of the system (such as early release schemes).

Fifth, holders of SMSFs cannot obtain compensation if they lose money in an investment. It would be useful to subject them to a levy to create a compensation fund. This would put them on the same basis as APRA funds. However, it could also create moral hazard. That is, funds might take riskier positions because they know they will be compensated for losses. It might, therefore, be necessary to impose some limits on portfolios which qualify for compensation. For example, the asset on which compensation is claimed is not to constitute more than 10 per cent of the portfolio. ■
Notes
1. Benefits can also be provided on termination of employment due to ill health or other specified conditions.
2. However, the deductible contribution will be reduced to $25,000 (from $50,000) in 2011-12 and this is likely to reduce the rate of growth of the funds.
3. The frontier in Figure 1 was calculated from annual data on software provided with Haugen (1997).

References
Clare, R. 2005, ‘Uniformity and diversity in superannuation fund investment portfolios’, paper presented to the 13th Annual Colloquium of Superannuation Researchers, Centre for Pensions and Superannuation, University of New South Wales, June.

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**RETAIL INVESTORS AND ETHICAL INVESTMENT**

Ethical and responsible investment markets have experienced phenomenal growth around the world in recent years and were relatively unaffected by the global financial crisis. This paper provides an overview of the framework for, and key issues involved in, ethical investing at the retail level in Australia. Ethical investment in Australia primarily involves screened portfolios, with limited activity occurring in community finance and shareholder advocacy. ¹

**Terms**

**Ethical or Socially Responsible Investment (SRI)** is a generic term covering ‘investment processes that combine investors’ financial objectives with their concerns about ESG issues’.² It is also known as ethical, sustainable or socially conscious investment, but these various terms cover different practices across the world. Ethical investment is generally defined to encompass three activities — portfolio screening (with regard to ESG issues), community finance and shareholder advocacy. Responsible investment encompasses engagement and activism (again, with regard to ESG issues), and integration (see Figure 1).

**ESG** stands for Environmental, Social and Governance issues. There are usually two key motivations for people seeking to understand these issues: they may want to impose an ethical screen on their investments or they may be concerned about the future price impact of such issues.

Screening is about restricting a stock universe. It can have two quite different motivations. A ‘Greenie’ may want to screen out coal miners due to concerns about the carbon emission externality. A fund manager may want to screen out coal miners because of concerns about the impact (on the value of the stock) of government action to address the externality.

Portfolio screening for ethical investment purposes is about deliberately including or excluding companies or sectors based on moral, ethical or religious concerns. The companies excluded must be legally open for investment.³ It may involve absolute ‘lexicographic preferences’, e.g. ‘no nuclear power plant operators whatsoever’, or materiality trade-offs, for example, ‘I’ll own electricity suppliers provided nuclear isn’t more than x percent of revenue’. The best-of-sector screening approach limits the companies that managers can include in their portfolios to those identified as the top

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¹ An earlier version of this paper was presented to the 16th Melbourne Money and Finance Conference — Retail and Household Finance: Current Issues. The conference was held in July 2011 by the Australian Centre for Financial Studies.

² See, for example, business-ethics.net.

performing in their sector, with regard to ESG criteria and challenges specific to their industry group.

On the other hand, negative screening — also known as exclusion — refers to an approach that excludes certain companies or even whole sectors from a portfolio on the grounds that they are involved in harmful activities such as tobacco, arms manufacture, publication of pornography, animal testing or gambling.

Norms-based exclusion is a specific form of negative screening. It involves excluding from a portfolio companies that are not compliant with international norms and standards such as those issued by the Organisation for Economic Co-operation and Development (OECD), the International Labour Organisation (ILO), the United Nations (UN), and the United Nations Children’s Fund (UNICEF).

Engagement refers to long-term dialogue with companies, with the aim of influencing their practices. The style and approach used vary significantly between different actors and in different countries. Engagement usually involves private negotiations. Shareholder advocacy is engagement plus filing and public support for resolutions with a view to improving returns and/or improving performance on ESG issues.

Community finance is the practice of making loans to or deposits with banks, deposit-taking institutions and finance companies that specialise in environmental or socially responsible lending.

Responsible investment as defined by the UNPRI (The United Nations-backed Principles for Responsible Investment Initiative) is ‘based on the premise that ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk-adjusted returns. It is therefore firmly within the bounds of investor fiduciary duties’. Responsible investment involves engagement (see above) and integration. Integration is the explicit inclusion of ESG risk into traditional financial analysis, which is often combined with engagement.

Legal background

Situation of retail investors versus trustees

In secular Western society, there is little to stop individuals from managing their finances according to their own ethics or whims, and as they see fit. There may be activities which it is illegal to finance and profit from (e.g. prostitution, illicit drugs, manufacture of cluster munitions). But otherwise, an adult of sound mind is free to make their own choices about: donations and investments; differing investment opportunities; and the extent to which they will free ride on other investors, e.g. taking dividends but not voting at AGMs.

Anglophone countries

An individual’s situation needs to be distinguished from that of a person who acts as a trustee of an investment fund. Trustees are not able to exercise their own whims in making decisions about donations and investments or when choosing between investment opportunities.

An individual’s situation needs to be distinguished from that of a person who acts as a trustee of an investment fund. Trustees are not able to exercise their own whims in making decisions about donations and investments or when choosing between investment opportunities.

> ‘to formulate … an investment strategy that has regard to …

> the composition of the entities investments as a whole including the extent to which investments are diverse or involve the entity in being exposed to risks of inadequate diversification.’

Similarly, in the United States, the Employee Retirement Insurance Savings Act (ERISA), passed by Congress in 1974, provides that: ‘A fiduciary shall discharge his [or her] duties solely in the interest of the participants and their beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan’ (section 404(a)(1)(A)).

Is ethical or responsible investment consistent with these obligations? Does the law make it acceptable for a trustee to finance the construction of a nuclear plant on top of a major geological fault, right next to the beneficiaries’ houses, as long as it provides them with a great financial return?
A famous UK court case addressed this question (Cowan v Scargill, 1984). Trustees appointed by the National Union of Mine Workers wished to prohibit the scheme from investing overseas or in energy stocks in competition with coal (e.g. oil, gas, nuclear).

In finding against these trustees, the judge made two important points:

Firstly, though trustees ‘... may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. Yet if under a trust, investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold’.

Nevertheless, the judge did not assert that ‘beneficial’ must be construed solely from a financial perspective even if the only object of the trust is to provide financial benefits.

The distinction between the individual situation and two variants of the fiduciary situation is set out in Figure 2. On the left-hand side of the diagram is the vanilla fiduciary situation where the members have gathered together defining their interests (e.g. a foundation or specialist ethical investment fund). In the vanilla situation, the equivalent of the ethical screen is ‘legal.’ Of course, the tailored fiduciary situation might focus on whim but mostly it will focus on externalities which the law hasn’t got to yet. The individual situation is shown on the right-hand side of the diagram. An adult of sound mind is free to apply whim, ethics, morals as they see fit and, if they choose, inconsistently from one day to the next.

If you’re a trustee in a vanilla fiduciary situation it isn’t relevant whether you think: climate change is a genuine issue; food manufacturers are responsible for obesity; it’s OK or not OK for businesses to deal with oppressive regimes. What is relevant is the risk that all these sorts of issues pose. If you’re an individual it’s no-one else’s business.
European countries
In Europe, at least eight countries have specific SRI regulations that cover their pension systems. However, despite the major step forward that these regulations represent, enforcement is still rather weak.

In France, two laws concerning SRI and pension systems were introduced in 2001, both inspired by the British SRI-disclosure regulation. Consumer protection and a desire to strengthen SRI-investments were the main reasons for the legislation. The February 2001 law changed many features of the French Employee Saving Plan laws, notably introducing an obligation that a fund’s internal rules and annual reports specify the way social, environmental or ethical considerations are taken into account. The second law requires the executive board of the Fonds de Réserve des Retraites (Retirement Reserve Fund) to report to the supervisory board on the investment policy guidelines and how these take into account social, environmental and ethical issues (Article L135-8, French Social Security Code).

Similarly, in Germany, in January 2000, the Parliament decided to establish an ethical, environmental, and social disclosure regulation in the new pension law. Newly conceived private pension schemes now have to fulfil a number of obligations — including the disclosure of SRI policies — in order to be certified and hence qualify for tax deductions.

In Norway, the size of the ethical investment market increased dramatically in 2004 with the introduction of ethical guidelines on the Norwegian Government Pension Fund, the largest pension fund in Europe and the second largest pension fund in the world. The fund’s guidelines are based on a combination of engagement, negative screening and exclusion.

And, in Sweden, since 2001, the five largest state-controlled pension funds have been forced to include environmental and ethical criteria in their investment policy ‘without relinquishing the overall goal of a high return on capital’.

Disclosure obligations on financial advisers and product vendors selling to the retail market
It’s common in the Anglophone countries for financial services law to insist upon accurate and complete disclosure including in the area of ethical investment.

It’s very rare to hear of any litigation or regulatory action in relation to such requirements. The only case the authors are aware of where a manager has been sanctioned for violating representations in relation to ethical screens involved a US company called PAX, which was fined US$500,000 for failing to screen its portfolio in accord with representations in its prospectuses.

Company law attitude to shareholder engagement and advocacy
One form of ethical investment is shareholder advocacy. The significance of this activity as part of the ‘ethical and responsible investment scene’ in a particular country depends a lot on the requirements set out in the corporation’s law of that country with regard to shareholders putting resolutions to meetings. These arrangements also determine the importance of retail investors in engagement and advocacy. In some countries, one shareholder is entitled to put a resolution. Evidently this encourages a degree of retail involvement in this activity. In other countries, only very big money interests can put resolutions.

The United States has the healthiest corporate democracy in this respect. Much of the resolution activity is coordinated by the Interfaith Centre for Corporate Responsibility (ICCR). The ICCR started as a non-denominational faith-based organisation. However, its membership now spans state governments, large institutional owners, investors who manage money on behalf of retail investors, as well as the core founding religious organisations. Each year, hundreds of resolutions are put to US companies on a wide range of ethical, social, moral, religious and environmental issues.

History of the development of ethical investment in Australia
This section describes the history of ethical investment in Australia focusing on retail participation.

Shareholder advocacy
Shareholder advocacy has virtually no history in Australia. Today there is one fund, ‘The Climate Advocacy Fund’, managed by Australian Ethical Investment, which has an advocacy mission. It is primarily a retail fund and was launched last year. It ‘lead-filed’ (developed and co-ordinated lodgement of) four resolutions in the 2010–11 AGM season. In almost every year dating back to 1996, surveys of ethical investment in Australia have contained a sad sentence to the effect that, ‘Yet again this year, there have been no specific shareholder resolutions related to environmental and social responsibility’. The few resolutions that have been dealt with at Australian listed companies’ AGMs have been ‘side show’ parts of union or green activist issue campaigns.

There are two reasons for this absence of shareholder advocacy history in Australia. One reason for this is the requirement of the Corporations Act that resolutions must have the support of 100 members or members holding at least five per cent of the votes.

The second, more significant reason for the absence of development of a culture of shareholder resolutions and democracy is the failure of intellectual leadership on the part of the Australian churches by comparison with the US churches. Just a decade ago, religious organisations were by far the largest identified ethical investors. They had the money, but in stark contrast with the United States, an ecumenical ‘universal owner/shareholder advocacy culture’ wasn’t established in Australia. Today, entirely unlike the situation in the United States, shareholder advocacy has a ‘ratbag’ connotation to some Australians.
Community finance

Also, unlike the situation in the United States, community finance has never been a substantial portion of the Australian ethical investment marketplace. The main reason for this is that Australia has always been a well-banked society. Currently, community finance represents about seven per cent of the total core ethical investment market. It is almost entirely retail and it has grown rapidly in recent years.7

Screened portfolios

To many Australians, ethical investment and screened portfolios are synonymous because community finance and shareholder advocacy have been fairly minor parts of the Australian ethical investment marketplace. The main features of the screened portfolio/ethical investment marketplace over the past two decades have been: rapid growth; significant broadening in the range of screening ‘styles’ on offer; increased significance of retail products; and continued disinterest on the part of mainstream adviser firms.

With regard to screening processes, there are no norms-based investment screens operating in Australia. In 2010, ethical exclusions and positive screening approaches each accounted for about one-third of the marketplace. Best of sector accounted for 14 per cent of the market and thematic investment accounted for 20 per cent. 8

In total, screened portfolios amounted to $15.4 billion in Australia in June 2010. That’s about 1.7 per cent of the total managed funds market. It is very difficult to split this into retail/wholesale. The bulk of it is ‘retail’ driven. For example, into a number of super funds offer their members an ethical responsible investment option, though the money may be invested in a ‘wholesale’ pool. As a general proposition, wholesale offerings are less stringent in their approach as compared with retail offerings. For example, while there is a retail super fund available that focuses solely on avoidance of cruelty to animals, there’s no similar wholesale offering. Broad responsible investment is much larger — about $75 billion in June 2010, accounting for 8 per cent of the market.

International comparison

Ethical/responsible investing has become a fast-growing worldwide phenomenon in the past 10 years and it is increasingly linked into mainstream fund management. However, the global ethical investment market is far from homogeneous, as a combination of cultural and legal differences deeply influence the shape of domestic markets. Ethical investment ‘marketplaces’ vary considerably in terms of size, growth, market share and strategy across the world.

Europe represents by far the biggest Socially Responsible Investment (SRI) market in the world, with close to five trillion euro under management,9 compared with a little over two trillion dollars in the United States (see Figure 3). Other significant markets — although far smaller — include Australia, New-Zealand and Japan. Interestingly, some emerging economies such as South Korea, Malaysia and South Africa have also recently seen a rise of investment in ethical funds.

Ethical/responsible investment markets have experienced phenomenal growth around the world in recent years and were relatively unaffected by the financial crisis; some markets even kept growing. The market grew at about 13 per cent in the United States from 2007 to 2010,10 now representing 12.2 per cent of the assets under management. In the US market grew at about 13 per cent in the United States from 2007 to 2010,10 now representing 12.2 per cent of the assets under management. The fastest growing area in the US market is community finance, which has grown over 60 per cent over the past three years. Likewise, 17 per cent of European assets are managed through a socially responsible approach, as a result of the European market growing at an average annual rate of 37 per cent between 2008 and 2010.

Retail ethical investment still accounts for a much smaller part of total ethical funds than institutional ethical investment across the United States (81 per cent11 institutional) and Europe (92 per cent). The split varies a lot between countries — in Germany and Switzerland retail represents about half the market.
One of the reasons that makes the global ethical investment market hard to describe is its rapid evolution. It is becoming increasingly hard to define and segment. Terms such as ‘best of sector’ and ‘screening’ cover different practices across the world, making cross-country comparisons a challenge. Nonetheless, some long-run trends are clearly discernable. For example, the Swiss prefer best-of-sector and thematic funds, whereas Norway and Sweden are the countries where norms-based exclusions are the most widely used, and engagement is mostly practiced in the United States and, to a smaller extent, in the United Kingdom and Norway. Interestingly, the gradual development of integration — as defined by the inclusion of ESG risks into traditional financial analysis — has become a global trend.

These national and regional differences in strategy, market share and growth of ethical investment can partly be explained by the diversity of political and financial traditions. The greatest difference is probably the long tradition of investment and application of ethical criteria to equity investment in the United States and the United Kingdom, compared with countries such as Spain, where stock markets are less significant. As a result, ethical investment markets are small and more oriented towards community finance in Southern Europe. Ethical financial products are mainly based on environmental criteria in Scandinavia and Germany, where environmental movements have long had credibility and access to political power. Investors in predominantly Catholic countries tend to favour exclusion strategies, screening out entire sectors such as alcohol, tobacco and weapons. Beyond ‘cultural’ particularities, differences in legal contexts go some way towards explaining these differences. The adoption in European countries of a series of laws making it mandatory for pension funds to disclose how they take ethical criteria into consideration has coincided with a strong growth in the market. Shareholder activism still remains infrequent in Continental Europe and Australia, mainly because of the legal hurdles that make it more difficult for shareholders to lodge a resolution at a company’s general meeting whereas, in US law, one shareholder is all that is required to lodge a resolution.

Conclusion
Ethical investment has three dimensions — screened portfolios, community finance and shareholder advocacy. Responsible investment has two dimensions — engagement and integration.

Responsible investment is a more recent development. In Australia, ethical investment is primarily screened portfolios. Community finance and shareholder advocacy are fairly minimal.

The development of screened portfolio options in Australia have been substantially driven by retail investors with some impetus from church groups. The Australian situation is quite different from that in the United States where shareholder advocacy has been an important feature of ethical investment largely driven, initially, by church funds. The ethical investment market in Australia is also quite different from that in Europe, where the market is proportionally much larger, and more institutionally based.

Notes
1. The views expressed are the author’s own. Howard would like to thank Damien Lynch, the pioneer of ethical investment in Australia for his inspiration. Further detailed information is available as appendices to the original paper presented to the 16th Melbourne Money and Finance Conference, see www.australiancentre.com.au.
2. European SRI Study 2010. There is a lot of variation in nomenclature in this area. In Europe it’s more common to refer to ‘Sustainable and Responsible Investment’ (SRI) and distinguish ‘Core’ and ‘Broad’ SRI which roughly correspond to ‘Ethical’ and ‘Responsible’ investment as described in Figure 1. The term ‘Ethical’ and the term ‘Responsible’ are also sometimes used as umbrella terms to encompass both ethical and responsible investment practice.
3. For example, in Belgium it is illegal to be indirectly involved in financing a company which produces cluster munitions. So, avoidance of companies involved in cluster munitions production isn’t ‘ethical investment’ in Belgium. This is further discussed in Attachment B to the original conference paper (available at www.australiancentre.com.au).
4. See www.unpri.org/taqs/
5. See www.belsif.be
6. Attachment A to the original conference paper (available at www.australiancentre.com.au) sets out these requirements in various western countries.
7. Average growth over the three years to June 2010 has been 25 per cent per annum.
12. The ethical approach of the Norwegian pension fund is described in Attachment C to the original conference paper (available at www.australiancentre.com.au).
HOUSEHOLD SAVING AND INVESTING FOR LIFE-CYCLE EVENTS: GOVERNMENT INCENTIVES AND INSURANCE BONDS

Individuals face difficulties in developing and executing optimal lifetime savings and investment plans, product complexity continues to grow, and there are increasing demands on government to support individuals’ financial needs. Within this context, this paper examines the rationale for government policies aimed at influencing household savings and investment decisions — focusing on the financing of life-cycle events and the design of suitable financial products to achieve desired outcomes.

If individuals are the rational, well-informed, homo-economicus of the textbooks, there appears little role for governments to interfere through taxes, subsidies, or grants to affect saving and investment decisions.

Taking that perspective, one reason for intervention could be the possible existence of externalities associated with those decisions, but these are hard to pinpoint. One exception might be that government welfare safety nets, such as the age pension induce sub-optimal life-time savings. Another reason for intervention might be equity (income redistribution) arguments — although micro-economic theory suggests that lump-sum transfers not attached to any particular form of expenditure are preferable because they maximise consumer choice and welfare.

However, there is considerable evidence from the field of behavioural economics that individuals do not act as the economics textbooks assume (Ritter 2003). Discount (time preference) rates appear to be too high to be consistent with optimal life-cycle savings and investment. ‘Framing’ of choices affects decisions, as does specification of ‘default options’ requiring an opt-out decision. Even though money is ‘fungible’, individuals appear to operate ‘mental accounts’ through which compartmentalisation occurs. Individuals appear to recognise their inability to voluntarily adhere over time to optimal plans and are thus willing to lock themselves into commitments for designated savings objectives over time.

Allied to these considerations is the prevalence of imperfect information. Not only do individuals have difficulty in assessing and factoring into their financial plans provisions for financially critical, life-cycle events, but the complexity of financial products is becoming increasingly incompatible with the general population’s relatively low level of financial literacy.

In this environment, bad financial choices can be made, and the opportunity and incentives for producing and promoting financial products, which involve excessive wealth transfer from purchasers to producers, are high. Regulators struggle to keep ahead of such innovations and to prevent the most odious cases, while reliance of individuals upon financial advisers to assist in decision-making has problems of its own.

Consequently, there is a case for examining whether and how government policies can best be designed to influence household saving and investment behavior in desirable ways, particularly by encouraging dedicated private saving for major life-cycle outlays. Such an approach, which some might regard as paternalistic, is partly a reaction to perceived deficiencies in the previous caveat emptor approach, which relies on the foundations of disclosure, education and financial advice.
Influencing savings–financial investment behaviour

It is possible to analyse the alternative approaches available to government by considering the tax/transfer treatment accorded to financial products at the three stages of their life. Special treatment can be accorded at the time of purchase, during the currency of the product, or upon maturity/exit from the product. There are also options for providing advantageous tax treatment, subsidies, or grants, and these mechanisms can involve either a direct benefit to the individual, or be delivered via preferential treatment of the product producer. Through competition the tax benefit in the latter method is (hopefully) ultimately transferred to the individual.

In Australia, the clearest example of tax/transfer approaches is superannuation. Following the Simpler Super changes of 2006, concessional tax treatment occurs in the following way. First, a tax concession is provided on purchase/entry, with individuals able to make contributions from pre-tax income. Second, a tax concession is provided during the currency of the product (the accumulation phase) through the preferential tax treatment accorded to superannuation funds at source on investment earnings. Third, exit from the product (the decumulation/retirement phase) sees accumulated earnings distributed ‘tax-free’ to the recipient.

In contrast, a bank deposit involves no special tax treatment on entry (funds are from post-tax income), interest income is taxed during the life of the product, and there is no tax at maturity. Table 1 illustrates various investment product types, where ‘T’ indicates full taxation, ‘t’ indicates concessional taxation, and 0 indicates no taxation. There are clearly substantial tax distortions across different financial products.

One issue with concessional tax treatment is that it is regressive in nature, with higher benefits (in the form of tax savings per dollar of investment) flowing to individuals on higher incomes and marginal tax rates. Moreover, the ability of higher income individuals to invest larger amounts in the product also increases the absolute size of their potential tax savings.

This can be overcome in several ways. One is by applying a tax rebate (where the income tax rate payable is reduced by a fixed amount across all marginal tax rates). A second is by payment of a government grant, either of a fixed amount or linked (possibly with a cap) to the

Table 1: Current Australian taxation of investment products

<table>
<thead>
<tr>
<th>Product</th>
<th>Entry</th>
<th>During</th>
<th>Exit</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings account (and term deposits)</td>
<td>T</td>
<td>T</td>
<td>O</td>
<td>Contributions are from after-tax income, earnings are taxed to individuals as they accrue on a 'flow-through' basis, and thus no requirement for taxation on exit when principal is returned.</td>
</tr>
<tr>
<td>Shares¹</td>
<td>T</td>
<td>T</td>
<td>t</td>
<td>Investment is from after-tax income, there is concessional treatment of dividend income (imputation) and deferral of tax on capital gains until realisation, and then at a concessional rate (if held for more than one year).</td>
</tr>
<tr>
<td>Complying Superannuation (funded schemes)</td>
<td>t</td>
<td>T</td>
<td>O</td>
<td>Contributions can be made from pre-tax income, there is a concessional tax rate (15 per cent on income and 10 per cent on capital gains) on super funds (i.e. a ‘tax-paid’ vehicle), and no tax is payable on withdrawal (past the preservation age of 60) and on death distributions to dependants (i.e. tax-free distributions).</td>
</tr>
<tr>
<td>Insurance Bonds</td>
<td>T</td>
<td>T&lt;10yrs</td>
<td>O</td>
<td>Contributions are from after-tax income, fund earnings are subject to 30 per cent rate (i.e. another ‘tax-paid’ vehicle) and no tax is payable on withdrawal (after the 10-year period) and on death distributions regardless of dependency (i.e. also tax-free distributions).</td>
</tr>
<tr>
<td>Owner Occupied Housing</td>
<td>T</td>
<td>O</td>
<td>O</td>
<td>Purchase out of after-tax income (and/or borrowed funds), imputed (self) rental income not taxed, no capital gains tax on sale.</td>
</tr>
<tr>
<td>Levered Rental Property or Equity investments</td>
<td>T</td>
<td>t</td>
<td>t</td>
<td>Purchase out of after-tax income, tax deductibility of loan interest, concessional capital gains tax (if held for at least one year).</td>
</tr>
</tbody>
</table>

See notes 1, 2, 3.
One issue with concessional tax treatment is that it is regressive in nature, with higher benefits (in the form of tax savings per dollar of investment) flowing to individuals on higher incomes and marginal tax rates. Moreover, the ability of higher income individuals to invest larger amounts in the product also increases the absolute size of their potential tax savings.

size of the investment. In both cases, some cap on the amount on which concessional tax treatment is available may be required on equity grounds. While both a tax rebate and grant can, in principle, be structured to have the same fiscal effect, there may be quite different public perceptions and thus incentives associated with each. Moreover, for zero or low tax rate individuals, benefits from a tax rebate will be zero or less than 100 per cent unless they are able to receive tax credits as a cash payment from the tax office.

Life-cycle events and international approaches

Figure 1 illustrates various life-cycle events that can require substantial outlays at different times throughout life. The timing, financial impact and likelihood of such events are often unpredictable, and some are discretionary. Alternative methods of financing such expenditures include: (a) prior savings to accumulate available wealth; (b) borrowing at the time of the event; (c) purchasing insurance, which pays out if the event occurs; and (d) intergenerational (family) wealth transfers. Because many of the events have a discretionary element, standard insurance is often not feasible, and borrowing (at reasonable cost) may not be feasible.

Consequently, governments here and overseas have adopted policies aimed at encouraging saving specifically targeted at particular life-cycle events. One motivation may be that, without incentives, individuals will have insufficient savings to adequately deal with these events. Where that outcome involves additional social costs as well as private costs (such as may be the case if further education by children is foregone, or dependence upon government welfare services result), the cost of government incentives may be outweighed by ultimate social benefits. Another motive may be that these policies are a form of targeted redistributive policies, where the association of tax concessions or subsidies with particular expenditures makes them more politically acceptable to the electorate. Compulsion, as well as tax incentives, is often a strategy.

A further motivation for such incentives is suggested by the view that an ‘asset accumulation’ approach to welfare policy or ‘asset-based welfare’ is worthy of more exploration. Using tax/transfer policies and grants (and compulsion) to encourage individuals to accumulate financial assets can lead to greater private responsibility.

FIGURE 1: Potential life-cycle events requiring significant funding

![Diagram of life-cycle events]

Source: Austock Life.
for dealing with possible life-cycle events, rather than reliance upon government welfare. Such involvement with the financial system may also help to promote greater financial literacy and help address widespread apathy, especially among lower income households, to actively engage in their personal wealth accumulation.

This ‘asset-based welfare’ approach initially popularised by Michael Sherraden (1991) as a method of assisting households to escape from the poverty trap, has been applied in a number of countries and related to a variety of life-cycle events. Tufano and Schneider (2008) provide a review of a number of such schemes, and they are also discussed in OECD (2003) and OECD (2007).

One type of scheme relates to Child Development Accounts found in countries such as Hong Kong, Singapore, South Korea, Belgium, Denmark, and the UK (OECD 2007). Such schemes provide incentives for families to build assets for children (and can facilitate intergenerational transfers) by providing concessional tax rates on earnings and withdrawals and/or government grants (bonus) related to contributions. Another type of scheme is related to Education, and examples include Canada, Singapore and the United States (OECD 2007). While generic tax-preferred savings schemes (unlinked to any final use purpose) have been introduced in a number of countries, many have subsequently been abolished.

Other types of schemes which can be found internationally include tax preference for life assurance policies which involve a savings element, while tax incentives/grants associated with investment in home ownership are commonplace. Most common is tax incentives and compulsion for retirement income savings. Of course, many such arrangements have the effect of moderating progressivity of the tax system by giving tax concessions on savings and investment products which those on higher incomes are best able to exploit.

**Life-event products and tax policy in Australia**

The tax treatment of financial products not only influences savings-investment decisions but, for long-term savings and investment products, the tax treatment essentially drives the generic product form and its design features. This can be illustrated by reference to superannuation and insurance bonds.

**Superannuation**

Superannuation is currently the most prevalent form of tax-paid investment, with tax concessions at all stages limited by rules governing investment amounts and access restrictions. ‘Tax-free’ distributions are made to investors after retirement and to financially dependent beneficiaries upon death.

While superannuation has become the predominant mode for accumulating financial resources, it has limitations for life-cycle financial planning in that it:

- is only about funding one life-cycle event — retirement;
- lacks design features for accumulating any form of lump sum provision, such as those often needed in retirement, for health, retirement accommodation and aged-care related outlays;
- lacks coverage across the whole community — often inadequate for the self-employed and non-existent for the ‘non- and never-employed’; and
- is open to the ‘double dipping’ by allowing lump sums to be taken and spent, with consequent demands on the age pension.

**Insurance bonds**

Insurance bonds offered by friendly societies and life offices are another tax-paid product, which allow investors to make lump sum or ongoing contributions into a fund with accumulated capital and earnings accessible on a tax-free basis 10 years (or longer) after the initial contribution, or at other earlier times in certain defined events (e.g. death, serious illness).

As a savings vehicle, investors are encouraged to contribute additional amounts of up to 125 per cent of the previous year’s contribution each year for the same tax-free maturity date. Contributions are made out of after-tax income and income earned within the fund is taxed at 30 per cent, with no distinction made between revenue income and realised capital gains. This tax treatment is advantageous (relative to direct investment in the underlying assets) for high income earners on marginal tax rates above 30 per cent, but less tax-favoured than superannuation and tax-disadvantaged for low income earners.

Because of their ‘life assurance’ characterisation, a ‘life insured’ person is nominated, who may be the investor or someone else. Accumulated funds can also be accessed before the 10-year period ends (with loss of some tax benefits) or are paid out (as a tax-free distributions) on death of the nominated life insured.

The 1980s and early 1990s were the heyday for insurance bonds, however, from the mid-1990s onwards, they lost support of financial planners and retail investors. A major contributor was the increase in the headline tax-paid rate to 30 per cent, from 20 per cent in the 1980s and 0 per cent previously, as was the removal of means-tested pension advantages. The ‘lost’ decade was also impacted by modest investment performance and antiquated investment structures concentrated on capital guaranteed business.

The insurance bond market today is seeing signs of new life with new entrants and existing issuers re-emerging with updated products and expansive investment menus using modern multi-optioned investment platforms.
Insurance bonds and life-cycle events

In the face of escalating challenges for Australian families, relating to educating children, home ownership, ageing, health care, and the work/family balance, there is merit in reviewing the tax treatment of dedicated products offering choice and ‘self-reliance’ options.

Insurance bonds are designed to build a lump sum to meet planned life-event objectives, or perhaps for unknown contingencies, or even as a nest-egg to draw down against over a future period. They can ‘lock-in’ the financial provisioning for important life-events — be it educating children or grandchildren, family health contingencies, aged care and accommodation, or for a funeral. Importantly, the ‘lock-in’ also allows an early withdrawal option at the cost of loss of tax advantages, providing a ‘safety valve’ for those investors whose circumstances change and involve a need for liquidity.

Despite the relatively complex tax treatment inside the life office or friendly society, the insurance bond is a relatively simple product with a structure and design features which can be easily explained to investors. As a life-cycle event savings product it holds simple attractions for specifically targeted and peace of mind investment outcomes. The merits of simple financial products requiring simple advice should not be underestimated.

Because insurance bonds are a species of life assurance and can be set up with a range of nominated of beneficiaries, they are suited to intergenerational transfers directed at a specific purpose. These types of nominations are also ‘ring fenced’ from disputes related to the estate of a deceased investor, and they have certain bankruptcy protections. There are minimal ongoing administrative/accounting requirements for the investor who does not need to include fund investment earnings in a personal tax return during accumulation or over the bond’s tax-free drawdown phase.

A variant on the standard insurance bond is an education scholarship plan issued by a friendly society for the explicit purpose of funding education expenses of the nominated beneficiary. The product design of the more recently developed friendly society education bonds draws upon elements of popular US and Canadian education products. Overseas experience shows that specialised education savings products are not only attractive from investment perspectives, but can also be powerful motivators, and assist in developing the child’s independent desire for a good education.

Refining the insurance bond model

Australia’s current approach to taxation of savings and investment products involves significant non-neutrality (AFTS 2010). Some part of that reflects explicit policy priorities, such as superannuation and home-ownership incentives, but other components, such as negative gearing into risk investments, are less well founded. More generally, there are relatively few incentives to help individuals become financially self-reliant and plan for the future through non-superannuation vehicles.

There are also well-recognised problems regarding financial literacy and the financial advice industry, which is generally only affordable for higher income individuals. In this regard, it seems appropriate to use the tax/transfer system to ‘nudge’ individuals into making financial choices better suited to their long-term welfare and consider an ‘asset accumulation’ approach to welfare policy, involving tax/transfer incentives to accumulate ‘merit assets’ providing (at least partially) for particular life-cycle events.

The insurance bond structure provides a potential vehicle for achieving these outcomes, but its use is currently inhibited by a number of tax design characteristics. Foremost among these is the ‘headline’ tax rate. At 30 per cent, it is double the nominal superannuation fund rate and there is no tax incentive (indeed disincentives) for lower income households to use this form of savings vehicle. It is also materially disadvantaged by the generous capital gains tax discount (which for higher taxed investors translates to a 23.25 per cent rate), and there is little discernable tax advantage relative to investors who use private trust and corporate structures where effective taxation can translate to an effective 30 per cent corporate tax rate or better.

Simply reducing the headline tax rate would enhance its appeal to individuals on higher tax rates, but would not benefit lower income groups. The overall budgetary cost would depend upon whether a lower headline tax rate induced high-income investors to substitute out of other more tax-favoured investments (such as negatively geared investment properties) or less tax-favoured products such as bank deposits.

And, any attempt to adjust tax rates in such a way as to provide benefits for, and induce targeted long-term saving by, low-income groups without creating further benefits for high-income groups seems likely to have the adverse effect of increasing product complexity. Central to the insurance bond’s appeal is its tax-paid nature and consequent non-flow-through of fund earnings to individuals’ taxable income. Because taxation of earnings is at the fund level, and there are no tax consequences on exit at maturity, there is no simple mechanism possible for applying differential tax rates for different contributors.

This suggests that a viable alternative would be to provide (capped) government co-contributions (grants) for lower income household contributions to a product which is targeted for specified purposes.

Here, however, the recent experience with the First Home Savers Scheme launched in October 2008 suggests some need for caution. Funds invested into tax-preferred deposit accounts received a government co-contribution and were locked in for four years, after which tax-free withdrawal to purchase a first home could occur. Contributions of at least $1,000 were required in each of at least four financial years. However, if house
purchase occurred prior to four years, funds invested could not be used for that purpose but were compulsorily transferred to a superannuation account and thus locked in until retirement age. Recent government changes to the product, which had had very little take-up, allow for the funds to be used to pay down the outstanding mortgage balance after the fourth year in that case. It is clear that the ‘lock-in’ period is an important consideration and, in that regard, the current 10-year investment requirement for insurance bonds is worthy of review. For most tax preferred savings products internationally, the term is typically shorter (such as four years). It is also clear that the consequences of the ‘early exercise’ option are important, with the loss of tax benefits associated with early withdrawal of funds from investment bonds more likely to appeal to investors than the compulsory transfer to superannuation if not used for a specified purpose such as in the original First Home Savers Scheme.

Conclusion
Clearly, individuals have difficulty in assessing and factoring into their financial plans provisions for financially critical, life-cycle events, and there are increasing demands on the welfare state to support the financial needs of individuals. In view of this, there is a case for examining whether and how government policies can best be designed to influence household saving and financial investment behavior in desirable ways. Government tax/transfer policies can be structured to influence savings and also influence the design of financial products to assist individuals in providing for their own life-cycle financial needs. When evaluated against other contemporary savings and investment vehicles (such as deposits, unit trusts and superannuation), there is merit in reviewing the insurance bond tax framework. The insurance bond framework promotes individual self-reliance and asset accumulation, and can operate as a form of ‘self-insurance’ by offering a disciplined investment environment, designed to encourage long-term savers. And, it has relatively low financial advice requirements. It may be advantageous to reduce the insurance bonds headline tax-rate, which would reinvigorate them as a voluntary savings facility, thus ‘nudging’ consumers towards the mentality of private funding for major life-cycle objectives and contingencies. Alternatively, government co-contributions could provide a way of targeting tax concessions at lower income groups.

Notes
1. Taxation of dividend income could arguably be viewed as non-concessional since franking credits offset company tax already paid and put the overall tax treatment of income flowing into a company equivalent to that paid out as interest on debt.
2. ‘Tax-paid’ means that during the accumulation phase of superannuation or an insurance bond, the fund or entity (i.e. life office including a friendly society) meets the fund/entity-level tax payments and reporting obligations, instead of personal tax being paid and reported by the underlying superannuation/bond investor.
3. ‘Tax-free’ means the investment proceeds of superannuation or insurance bonds, when able to be accessed post-preservation for superannuation and post-10 years for insurance bonds, or upon death maturity distributions for both, are distributions generally free of personal tax obligations in the recipients’ hands.
4. Between the Life Offices and Friendly Societies — Industry FUM is estimated to have peaked at over $40 billion.
5. The special feature of these schemes is that withdrawal of funds for eligible education expenses leads to recoupment of the tax-paid on earnings by the fund.
6. The recently announced proposals to provide a 50 per cent discount on the tax rate on the first $1,000 of income is also relevant here.
7. Of note, prior to 1982 Australian insurance bonds were subject to a four-year ‘lock-in’ period.
8. The evidence on how compulsory savings plans (such as superannuation requirements) and tax concessions affect overall savings levels is mixed (Japelli and Pistaferri 2003). Attanasio and Wakefield (2010) examine the empirical evidence on how changes in returns on particular products, such as from specific tax changes, affect savings and wealth and also find mixed results, but suggest that the way in which information is presented may be an important determinant of responses.

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Tax distortions are traditionally measured using marginal tax rates, or real effective tax rates (Henry Review Panel), empirical studies have identified six margins where tax affects investment decisions. Measuring selected Australian savings vehicles against those margins highlights tax distortions affecting retail investor behaviour. These findings have significance for tax policy makers and financial institutions, and for the current policy debate about the standards of tax knowledge mandated for financial planners and the exemption from financial advice licensing for tax professionals.

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tax rate, a defined asset holding period, an assumed inflation rate, a given level of leverage (where applicable), and independently of other asset holdings. However, understanding how tax affects decisions about asset allocation (including methods of holding and financing assets, and trading decisions) requires consideration of more than the RETR.

Poterba (1999) studied US household savings data to understand the behavioural effects of tax and determine the efficiency of the tax rules. The study sought to explain stylised patterns emerging from the behaviour and how tax incentives for portfolio assets affected interpretation of empirical results on non-tax variables. To undertake analysis of the data, he identified six margins along which investor behaviour with respect to tax could be considered. They are:

- asset selection — which assets to hold;
- asset allocation — how much to invest in each asset;
- how much to borrow;
- asset location — legal structure within which to hold the asset;
- whether to use a financial intermediary; and
- when to trade the asset.

The purpose of this paper is to categorise selected Australian savings vehicles along those six margins in order to examine tax distortions. This data can then be used to inform tax policy makers about the efficiency of the savings vehicles.

In addition, because those categories or margins overlay portfolio management concepts to taxation, it can be used to inform two current policy debates. The first is a debate about the minimum standard of tax knowledge that financial planners must have, and the second is about resolving the regulatory overlap between tax accountants advising on tax efficient savings structures and financial planners advising on tax efficient investments (Shorten 2011).

While the Poterba study excluded non-financial assets and structured financial products, these are included in this paper because of the importance of owner-occupied housing, business assets, rental housing and structured financial products as savings vehicles for Australians. This paper demonstrates that tax rules distort the way that individuals invest by using six ‘margins’ as used in the Poterba study, suggesting that policy makers consider reforming the tax rules to prevent these distortions.

Asset selection

Asset selection means which assets retail investors will hold as part of their portfolio, and Poterba (1999) observed that asset selection is largely a function of the marginal rate of tax (MTR).

The Panel considered the taxation of a limited number of savings vehicles in terms of their tax neutrality by comparing their respective RETRs, which emphasised the tax distortions and, implicitly, their attractiveness as an asset class to retail investors. For the savings vehicles that were compared, the Panel observed that interest has the least favoured tax treatment. In contrast, shares benefited from the CGT discount and domestic shares from imputation credits. Rental properties benefited from the immediate use of losses but deferral of tax on gains, with their attraction further ‘driven by the CGT discount and exacerbated by leverage’ (AFTS 2010). Owner-occupied housing was zero taxed. These non-neutral treatments resulted in the recommendations of the Panel already mentioned.

Perhaps the most important tax preference of an asset class is shares in Australian companies that pay franked dividends. Broadly, Australian taxes paid by companies are imputed to shareholders who must include them as income but are entitled to a tax offset equal to the amount of the included credit. As the imputed tax credit is 30 per cent, shareholders whose MTR is equal to or less than that pay no tax on the dividends and are entitled to a refund if they are in tax loss: this makes these shares particularly attractive to superannuation funds. In addition, Australian shares benefit from the tax efficiencies associated with buybacks, where subscribed capital can be returned as an imputed dividend, with a potential tax loss.

As a way of mitigating the over-taxation of interest, the Government announced in the 2010–2011 Budget a 50 per cent tax discount on up to $1000 of interest earned by individuals on bank deposits.

Australia seems to have a heritage of financial products that are structured around tax distortions designed to be attractive to retail investors.
Australia seems to have a heritage of financial products that are structured around tax distortions designed to be attractive to retail investors. Historical examples include dingo bonds (striped Treasury bonds), infrastructure bonds (which were abandoned by the Government when the pipeline had $4 billion of potential issuances) and insurance bonds issued by (then) low-taxed mutual insurance companies, and which seem to be coming back into vogue (see below).

More recently, the finance markets have developed structured tax efficient retail investments, for example REITs (real estate investment trusts), that use borrowed funds to distribute tax-deferred, rather than taxable, distributions to investors (Davis 2009). Stapled-listed securities, which preserve capital allowances for retail investors, are also available.

Asset allocation

Asset allocation refers to how much of a portfolio is invested in each type of asset. Australia has a very high level of owner-occupied housing. Indeed, ‘66 per cent of the wealth at the fifth decile of the 65 and over age’ is in that asset class, although it is not clear whether that high rate reflects the way that it is taxed (no relief for interest or maintenance costs and proceeds on sale tax free) or whether it reflects its exclusion from the age pension means testing (Disney 2009).

Acquisition of owner-occupied housing has immediate tax inefficiencies in that non-deductible interest on funds used to acquire it has to be paid with after-tax income. Arguably, it is more tax efficient to retire non-deductible debt than contribute to a superannuation fund, thereby distorting what part of a portfolio is allocated to either (Knox 2003).

Financial institutions have attempted to exploit this distortion by offering a ‘split’ loan whereby part of it funded domestic housing and the other part funded an income producing investment, where the borrower could aggressively pay down that part for housing and defer repayment of that part for investment. This was subsequently disallowed by the High Court (Firth 2002).

However, the tax wedge between contributing to a superannuation fund or financing owner-occupied housing has, in principle, been mitigated by the First Home Owners Savings Accounts scheme. Under this scheme, depositors who contribute up to $5,500 under certain terms to an account that will be used to purchase a first home will be eligible for a Government contribution of $935 and earnings on the account are taxed at 15 per cent. If the funds are not used to acquire a house, they must be transferred to a superannuation fund.

Yet, notwithstanding the Government bonus and a tax rate equivalent to superannuation, they have not proved attractive as only 19 ADIs offer them and, as at 2010, there were only $110 million in 22,600 accounts, compared with the forecast of $6.5 billion by 2012 when introduced. This lack of attractiveness, however, has been attributed to the four-year lock-in requirement, rather than to tax factors (Johnson 2009).

Many households are also business owners and there are four tax features that influence the allocation of a portfolio to assets used in a business. First, business owners are outside the compulsory superannuation contribution system leaving them to use funds that otherwise would have been contributed to superannuation to acquire business assets.

Secondly, the Australian taxation system gives significant concessions on the sale of business assets provided that the owners’ total CGT (capital gains tax) assets are less than $6 million (or turnover is less than $2 million p.a.). Where these businesses are taxed, it is on a realisation basis, which provides tax deferral benefits and, also, efficiency benefits arising from the ability to control when the tax is paid.

Thirdly, the tax system implicitly recognises that business assets are a form of retirement funding and, in that regard, it integrates the taxation of business assets with the superannuation system. Business owners are given generous tax concessions in the form of increased contributions limits if they apply the non-taxable proceeds of the sale of their business assets to a super fund, implicitly suggesting that business owners should invest in business assets first and catch-up on superannuation later.

Fourthly, regulatory concessions allow business owners to transfer their business premises to their superannuation fund provided it is a self-managed superannuation fund (SMSF). This means that the business owner is then paying rent deductible at their MTR to their superannuation fund that is taxed at 15 per cent.

Finally, Australian superannuation funds have one of the highest allocations to equities among OECD countries. This is due to the previously mentioned attraction of imputation credits and the CGT discount. Indeed, such an allocation on the basis of preferential tax outcomes has been seen as ‘a questionable practice’ in terms of appropriate asset/liability management practices (Bateman and Kingston 2010).

How much to borrow

Treasury estimates that 70 per cent of rental accommodation provides a tax loss for owners. Australia is unique in that any annual tax loss from owning rental accommodation (where the interest and maintenance expenses exceed the rental income — negative gearing) can be offset against any other class of income (AFTS 2010). The United Kingdom, for example, requires that such annual tax losses be carried forward and offset only against the sale proceeds.

The Australia system positively discriminates in favour of negatively gearing equity as the borrower, in addition to claiming the tax loss against any interest earnings, is also
The Australia system positively discriminates in favour of negatively gearing equity as the borrower, in addition to claiming the tax loss against any interest earnings, is also able to access imputation credits.

able to access imputation credits. The Panel commented that negative gearing leads to taxpayers taking on excessive risk and distorts the allocation of resources in the economy (AFTS 2010).

Borrowing for the tax preference also seems to play a large role in structured retail investment products, such as agribusiness schemes and instalment warrants. In the case of agribusiness schemes, which is where the investor leases a small parcel of land and engages the promoter to plant, maintain, harvest and sell trees, the promoter often lends the investor part of the cost to establish the scheme and pay the first year’s maintenance fees.

Instalment warrants, which are effectively deferred equity purchase agreements with the purchaser entitled to the imputation credits before the loan has been repaid, is an example of a tax distortion that was corrected in the 2011 Budget. The cost of the put option that protected the borrower against a fall in value of the asset had been included as part of an undifferentiated fee, including interest, which was fully deductible. Had the option cost not been ‘wrapped-up’ with the interest payment, the tax result would have been different (Brown and Davis 2005).

Asset location
Asset location refers to the legal structure within which the assets in a portfolio are held. In the Australian context, the most obvious tax aspect influencing where assets are held is the tax preferences given to superannuation funds (although the ability to use the tax benefit is limited by the contribution caps). Indeed, for an investor over age 60, a superannuation fund that has paid tax and is now paying a pension is, in effect, a tax-free savings vehicle with neither tax on earnings or on distributions. As already noted, holding Australian shares in a superannuation fund has significant tax benefits creating a strong bias in investor behaviour towards them.

Superannuation funds are able to borrow to acquire assets, subject to the loan being non-recourse. Nevertheless, given the low tax rates in a superannuation fund, the question arises as to why an investor on a higher personal MTR would borrow in the fund rather than borrow directly? The reason is that while the tax savings from the interest deductibility will not be as great inside the fund as if the borrowings were direct, any gain when the asset is disposed of will only be taxed at 10 per cent or zero. This is preferable to a 50 per cent CGT discount even if the individual is in a moderate or high tax bracket at the time of disposal.

There are three other distortions associated with the use of a superannuation fund.

First, investors only gain access to the Government co-contribution if a contribution is made to a superannuation fund.

Secondly, the contributor can redirect employment income (otherwise taxed at their MTR) which is taxed at 15 per cent and with no fringe benefits tax liability (salary sacrifice).

Finally, superannuation funds can be used to transfer prior-year contributions from one spouse to another without incurring tax so that sacrificed salary in one year can be transferred to a spouse tax-free in a subsequent year. Internal reallocation of fund assets to spouse’s accounts are also non-taxable.

Financial Intermediary
A key decision for investors is whether to use a financial intermediary or to invest directly.

Largely, the choice of using a financial intermediary, rather than investing directly, is determined by non–tax issues such as the Management Expense Ratio (MER), ease of investment and access to otherwise inaccessible asset classes.

However, there are several tax aspects that influence the decision about whether to use a financial intermediary. The first is with respect to the efficient use of tax losses in a portfolio, where tax losses in a portfolio held directly can be used more efficiently, compared with their use in a portfolio held by a financial intermediary. A fund manager, for example, will not have regard to the individual investor’s tax situation when managing the fund’s tax losses.

Secondly, the tax characterisation of disposals can change in a financial intermediary (although this is under review (Exposure Draft)). For example, gains on disposal in a financial intermediary may not be entitled to the CGT discount, whereas there is a very low risk of that in a portfolio held directly.

Thirdly, the tax efficiency or otherwise of a financial intermediary is opaque as they report their returns pre-tax. However, that is currently changing with a number of fund managers now reporting returns to investors on an after-tax basis.

Finally, a tax preference which favours the use of financial intermediaries is re-emerging in the form of insurance bonds (Davis, Ralston & Higgins 2011). These are the only investments available in Australia that have rolled-up earnings at the corporate tax rate. This is attractive to investors who do not need annual distributions and who would otherwise be taxed at a MTR above that.

One particular issue that needs further research is whether there is any tax aspect that affects the choice between using a public offer superannuation fund rather than a SMSF. While a SMSF is technically not a direct investment,
because the trustees who manage the investment and the investors are the same people, it is, in effect, a direct investment. The tax laws do not discriminate between SMSFs and other types of superannuation funds, but regulatory laws do. The ability of a super fund to hold the contributor’s business assets is not available to super funds run by financial institutions, only SMSFs. Generally, the reason for investors to use a SMSF revolves around control of the investment, rather than the tax effect (SPAA/Russell 2011).

When to trade

Obviously the entitlement to the 50 per cent CGT discount (or 10 per cent nominal discount for a superannuation fund) depends on the asset having been held for at least 12 months. More importantly with respect to CGT, because it is a realisation-based tax, is the ‘lock-in’ effect where an investor will be reluctant to trade an asset because of the tax that will become payable.

Perhaps another tax aspect that impinges on the decision about when to trade is the MTR of the investor. The maximum value of negative gearing, for example, is achieved where the deductions are claimed when the investor has a high MTR and the tax on the sale is paid when the investor’s MTR is low (such as when they have left the workforce or a superannuation fund is in pension mode).

Conclusion

Tax distortions are traditionally measured by reference to MTR or, in the case of the Panel, RETR. However, this paper demonstrates that tax distortions of selected savings vehicles are also evident when viewed through the six margins identified by Poterba.

Clearly, viewing tax distortions in this way is important for tax policy makers, but given the interplay between investment management practices and tax efficient investment practices in these margins, this approach also has important implications for the public debates about the standards of tax knowledge mandated for financial planners and the exemption from financial advice licensing for tax professionals. It also has particular relevance for financial institutions in designing products for retail investors.

Notes

1. The inequity for superannuation contributors whose MTR is 15 per cent or less is in the process of being resolved (Treasury 2011).

2. In addition, an investor can borrow on a full-recourse basis and then on-lend the funds to the superannuation fund on a non-recourse basis as a method for getting around the contribution limits. The increase in the value of the asset accrues to the account of the superannuation fund but the credit risk on the borrowing resides with the investor.

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Much of the recent focus on superannuation policy outcomes and settings has related to the accumulation phase, and considerable work remains to be done regarding the post-retirement phase. Although the Henry¹ and Cooper² reports raised a number of important post-retirement issues, their recommendations provided only a partial response to the challenges involved. This paper outlines these challenges and provides potential policy options to address them.

Increasing longevity — implications
Over the next 40 years, the number of Australians aged 85 and over is projected to more than quadruple, from around 400,000 in 2010 to 1.8 million by 2050 (Treasury 2010). The ageing of our population is largely in response to improvements in life expectancy. In 1983, an Australian female reaching the age of 65 could expect to live, on average, for another 18 years, while an Australian male could expect to live for a further 14 years. By 2002, these figures had risen to 21 years for females and 18 years for males. Despite increased superannuation savings, a substantial proportion of these will have only modest savings to fund their retirement.

Most Australian retirees take lump sums or make use of account-based income streams. Currently, sales of life annuities and deferred annuities are minimal although term annuities are becoming more popular. Tax and other policy settings are likely to have played an important role in generating this outcome of very limited use of market-based longevity products. However, as a result, the attendant longevity risks and demands largely fall upon the government-provided age pension. A key argument of this paper is that both incentives and compulsion are needed for greater take-up of retirement income streams providing longevity protection for individuals post-retirement.

Available post-retirement products
Post-retirement products are any financial products provided through a superannuation fund or scheme, or other financial institution, which enable an individual and/or their dependents to meet their income needs in retirement. These include the following products.

Pensions
A pension is a regular stream of income, payable from a superannuation fund. Many defined benefit schemes provide an income stream until death, with no residual value. At least partly because employers have generally closed entry to such defined benefit schemes to new employees, most Australian retirees have been opting for account-based income stream pension products (often referred to as allocated pensions). These provide for accumulated superannuation monies to be invested to generate income in the account, with withdrawals above some minimum amount related to account size required by government. In the event of death, the remaining account balance accrues to the investor’s estate or dependents.

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Such products involve two major risks for the retiree. One is that the capital and earnings can run out before a person dies (longevity risk). The other is investment risk, reflecting the variability of returns and thus the size of the available funds from which an income stream can be drawn.

Annuities
An annuity is an income stream purchased by payment of a lump sum to a financial institution. That income stream is payable for a set period (usually referred to as a term annuity), or for life (lifetime annuity). The latter obviates longevity risk. Investment risk is also borne effectively by the product provider rather the investor — arguably a more suitable allocation of risk for those in retirement, although it does come at a cost in terms of the price paid for the annuity.

Other post-retirement products
There is a small, but growing, number of products where investment and longevity risks are shared between the customer and the product issuer. Some products offer (for a price) market-linked returns plus an income and/or capital guarantee and some also protect investors against longevity risk. Outside superannuation, investments such as bank term deposits, shareholdings and investment properties can be used to generate investment income in retirement. Reverse mortgages also are used by a small minority of retirees.

Why retirement products are appropriate for retirees
For the great bulk of the population, the age pension is not considered to be sufficient to meet retirement needs. The ASFA Retirement Standard (Howell 2009) estimates that the annual expenditure currently required (as at March 2011) by a couple for a modest standard of living in retirement is $30,700 and for a comfortable lifestyle it is $53,880. While overall expenditure needs may decrease with age, recent work by ASFA indicates that at age 90, the expenditure needed for a modest lifestyle is only marginally lower (than $30,700), while for the comfortable level it is about 10 per cent lower (than $53,880). The age pension is not sufficient for a modest lifestyle.

Recent estimates produced by the Treasury RIM Group (Rothman 2011) indicate that on current policy settings in regard to compulsory contributions, around 70 per cent to 80 per cent of future retirees will reach the modest lifestyle level, at least in the first five years of retirement. Only 20 per cent to 30 per cent of retirees are projected to reach the comfortable level.

Post-retirement products assist individuals in reaching these expenditure levels in retirement. Retirees also have the capacity to supplement other forms of income, which can include more generic investments, casual or part-time employment income, and receipt of the age pension.

Managing risks associated with private retirement savings is an important consideration in relation to the design of post-retirement products. These risks include ‘consumer risks’ such as longevity risk, ‘conservatism’ risk (that individuals might under-spend due to worries over running out of money) and ‘advice risk’ (that bad financial advice is given exposing the retiree to inappropriate products).

Also relevant are ‘product risks’ including: inflation risk (deterioration in the purchasing power of income streams); investment risk (of either or both excessive downside risk, capital loss, and inadequate exposure to potential upside gains); ‘time-of-purchase risk’ (being locked into a product with poor returns because rates are unfavourable at the time of purchase); ‘irreversibility risk’ (making a purchase decision which does not turn out to best meet income needs and which cannot be easily reversed); and ‘counterparty risk’ (of the provider defaulting on their promised obligations).

As well as protection from risk, individuals look for varying levels of flexibility from their retirement savings. Account-based income streams tend to have more flexibility but they also have greater exposure to a number of the risks set out above.

Other more structured retirement income products protect against a number of the risks outlined above, but at a cost built into the price and/or characteristics of the financial product (including limited or no access to capital once the product is purchased).

There is no ‘perfect’ retirement product which will meet the needs of every retiree. Preferences and circumstances will differ between individuals and it may be necessary for a retiree to make use of a range of post-retirement products.

Encouraging better take-up of post-retirement products
A number of policy levers might be considered to encourage or require greater take-up of post-retirement products. Incentives can encourage individuals to actively seek out appropriate retirement products. Default arrangements can nudge retirees into what are considered desirable products from a public policy point of view.

Finally, mandating minimum requirements ensures that there will be better take-up, albeit at the cost of flexibility and individual choice.

In this context, possible specific policy levers would be to:

- require retirees to spend a proportion of the value of their superannuation benefits to purchase longevity insurance (mandating);
- impose both minimum and maximum payment requirements each year in income stream products to protect against premature exhaustion of savings and to ensure that tax-preferred retirement savings are actually used for retirement;
More generally, attention should be given to how principles of behavioural finance can be used to ‘nudge’ individuals into desirable decisions about post-retirement products. ‘Nudging’ individuals can provide most of the outcomes desired from a public policy point of view without imposing arrangements that may not always be appropriate or desired by specific individuals.

- offer Centrelink means-tested incentives to encourage individuals to invest some proportion (e.g. more than 25 per cent) of their superannuation in longevity insurance or income stream products; and
- specify a default retirement product for superannuation fund members who do not actively engage in retirement planning.

More generally, attention should be given to how principles of behavioural finance can be used to ‘nudge’ individuals into desirable decisions about post-retirement products. ‘Nudging’ individuals can provide most of the outcomes desired from a public policy point of view without imposing arrangements that may not always be appropriate or desired by specific individuals.

These behavioural finance principles include: specification of appropriate defaults (such as regarding investment mix and drawdown arrangements); promoting life-cycle savings culture norms; and framing available options in ways which encourage the take-up of public policy preferred post-retirement products.

Increasing the supply and attractiveness of longevity products

Regulatory settings — flexibility
Investment risk and longevity risk are interrelated and any move to push retirees into more conservative investments in retirement may increase their longevity risk, which is, arguably, the more significant of the two.

However, there are regulatory impediments that may be making certain post-retirement products more expensive and/or otherwise less attractive than they might be. For instance, some current regulatory provisions restrict product development in the retirement space. Income Ruling IT 2480 and SIS regulation 1.06 (2) basically assume that products are either account-based or a pension, and do not deal well with products that have elements of each or have certain benefits that are deferred. This makes the regulatory process more complicated and it also increases the costs of such products. Withdrawal or amendment of the Ruling and the SIS Regulation would assist both the development and marketing of products providing protection against the financial consequences of longevity.

As well, product providers must deal separately with the ATO, APRA, ASIC and Centrelink, further complicating the product development process. Also, there are little or no tax and social security incentives for taking a retirement benefit in the form of an income stream as opposed to a lump sum, and no real incentives for purchasing a product which provides protection against the financial consequences of longevity.

More education and advice to fund members
Better take-up of post-retirement products is also likely to occur when superannuation fund members are better educated and advised about such products.

In this regard, the scaled advice model mooted under the Future of Financial Advice reforms is intended to enable trustees (or those employed by them) to discuss issues such as adequacy of superannuation accumulation, interaction between the member’s superannuation interest and Centrelink entitlements, and nomination of beneficiaries (all of which are retirement issues), within the intra-fund advice framework.

SMSFs and access to longevity protection
At present, capital gains are taxed when a person transfers funds from a self-managed superannuation fund (SMSF) to a post-retirement product in an APRA-regulated superannuation fund offering. This may inhibit the purchase of products which provide longevity protection if provision of such protection via a SMSF is more difficult or expensive.

Other retirement policy issues
Retirement is not necessarily an either/or (full-time work or not work) decision, and policy development also needs to focus on a number of issues regarding the interaction of labour force features with retirement. In particular, some part of the income needs of those of retirement age can be met by full-time, part time or casual work and, in this regard, the impact of policy settings (and societal attitudes) on the market for older workers warrants examination.

Specific links exist between superannuation policy and product provision and the current superannuation settings with regard to preservation and early retirement. Some superannuation schemes encourage early retirement through maximising benefits at certain ages, such as age 55 or 58. The merits of providing incentives for such employees to continue in employment (or ultimately removing early-retirement incentives) also warrant attention; so does developing more effective transition to retirement tax and other policy settings to retain older workers in the paid labour force.

Age-related contribution rules and the upper age limit for SG contributions are also important considerations from a policy perspective, with the proposed increase in the maximum age for receipt of Superannuation Guarantee
contributions likely to encourage (albeit marginally) longer workforce participation.

Increasing age leads to increased rates of disability and greater need for residential care facilities. Residents of such facilities are generally required to provide both a capital amount in the form of an accommodation bond and ongoing contributions for the costs of care. For a society with an ageing population structure, it should be a priority that policy settings are put in place which facilitate the financing of such expenses, together with the development of retirement products that address the expense requirements of older retirees. Methods of pre-funding or making allowance for aged care accommodation bonds also need to be compatible with post-retirement income products that are sold or are required to be purchased.

Increased age also brings decline in cognitive abilities and thus the capacity to manage individuals’ own retirement finances. Consequently, regulatory and fiduciary frameworks in superannuation need to have sufficient flexibility to enable SMSF trustees to easily transition their investments back into APRA-regulated superannuation. This would enable trustees of SMSFs to transition members who are mentally incapable of managing their own affairs back to a default investment strategy for retirement.

The Henry and Cooper Report recommendations on retirement incomes

Both the Henry (AFTS 2009) and Cooper (SSRFR 2010) reports made a number of recommendations that are relevant to post-retirement products. However, neither report provided (or indeed intended to provide) a comprehensive package of recommendations dealing with post-retirement issues.

A further complication in considering the Henry Report recommendations is that they were designed to be considered as a package and interact with other recommendations relating to personal income tax. The Government has not adopted the great bulk of these latter recommendations.

Some of the Henry recommendations, if adopted, would assist in ensuring greater supply and take-up of post-retirement products but a number of the recommendations would actually make post-retirement products less attractive.

For instance, it would be a step forward if the recommendation were adopted that the Government issue long-term securities, where this is consistent with its fiscal obligations, in order to help product providers manage the investment risk associated with longevity insurance. One of the current constraints in relation to the development of products dealing with the financial consequences of longevity is the need to match liabilities stretching over a number of decades with assets held by the provider. Long-term securities are of considerable assistance to providers both in pricing and facilitating longevity products.

It would also be helpful for government to adopt the recommendation that it make available the data needed to create and maintain a longevity index; this would assist product providers in hedging longevity risk. Currently, this data is not readily available and often providers have to make use of partial and/or overseas data.

Less helpful was the recommendation that investment earnings of assets supporting income streams in retirement (currently untaxed) should be taxed at 7.5 per cent p.a. While the Henry Report recommended that the rate of tax on investment earnings during the accumulation phase be reduced, the overall impact would be to remove an incentive to take an income stream within superannuation rather than a lump sum.

The Henry Report also recommended that the Government become a direct provider of immediate and deferred annuity products. This was something the Government has ruled out, for good reason. Governments do not have any particular expertise in such products. The report did not demonstrate any market failure that only direct government provision could remedy. While government could provide such products at a lower cost than private providers, this would only be possible if it were at the cost of taxpayers more generally. Government involvement as a provider would also discourage private providers from becoming involved in immediate and deferred annuity products.

There were a relatively small number of recommendations relating to post-retirement issues in the Cooper Report and, hence, in the Stronger Super decisions by the Government (Shorten 2010). One such recommendation, that consideration be given to default retirement products for some members, is designed to ‘nudge’ retiring fund members into appropriate post-retirement products. The MySuper Working group considered that this policy work would need to be completed by the end of the MySuper transition (2015) in order to deal with the needs of the new wave of retirees and recipients of the age pension — the baby boomers.

The change process

While bringing about change in post-retirement policies may not be easy, a number of activities will assist in bringing it about. These include:

- development of a consensus across the superannuation industry on what should be the goals in the post-retirement phase and how these might best be addressed;
- development of a political consensus on the importance of post-retirement issues;
- providing a stable regulatory and tax environment for post-retirement products, which is also clear and understandable so that individuals can plan with confidence for the future;
- undertaking comprehensive research and consultation before any measures are put in place so as to
better meet objectives and avoid any unintended consequences; and
> undertaking a program of public education on post-retirement issues and how to plan better for retirement.

Conclusion

Compared with most other countries, Australia is unusual in that, apart from a small minority of individuals in defined benefit funds, the great bulk of Australian retirees take lump sum benefits or maintain an account-based income stream in retirement.

While account-based income streams provide considerable flexibility for retirees, they provide relatively little protection against the financial consequences of living beyond average life expectancy. Such account-based products also expose the retiree to variations in both investment returns and in the capital value of assets supporting the income stream.

There are sound public policy grounds for supporting greater take-up of income stream products which provide protection in relation to the financial consequences of longevity and/or variation in investment returns.

Increasing support for such products is likely to require a variety of measures. These include removing regulatory and tax impediments to the development of new post-retirement products, ‘nudging’ retirees to take-up such products through the setting of appropriate default arrangements, and compelling retirees to insure against the financial risks of longevity in appropriate cases.

Notes

3. Strictly speaking, it is a cash flow stream involving a return of the original capital and income earned on that (declining) capital.

References


Rothman, G. 2011, ‘Projecting the adequacy of Australian retirement incomes’, paper to the Nineteenth Annual Colloquium of Superannuation Researchers, University of New South Wales, July.


Treasury 2010, Australia to 2050: future challenges, the 2010 intergenerational report, Canberra.
WEBMASTER RECOMMENDS

Update on ETFs and options, mortgage resources and tools, and corporate governance

Financial markets

New ETF information for investors
www.moneysmart.gov.au

On 15 August 2011, the Australian Securities and Investments Commission (ASIC) published new information on its consumer finance website, MoneySmart, to help consumers understand the different types of exchange-traded funds (ETFs) and their risks.

In recognition of the growing popularity of ETFs in Australia and the need to help investors understand the risks and other considerations associated with them, ASIC has started a review with the aim of identifying and assessing the risks associated with both standard and synthetic ETFs. The review will seek to clarify the impact of these risks to Australian investors. It is envisaged that the review will involve discussions with participants of the ETF industry in Australia.

ASX celebrates 10 years of listed ETF trading
www.asx.com.au under Products then Managed Funds

On 27 August 2011 it was the 10th anniversary of the listing of the first ETF on the Australian Securities Exchange (ASX). August 2011 also marked the 1st anniversary of the ASX ETF Market Maker incentive scheme. The historical data is recorded in the ASX ETF monthly report to be found at the website above.

ETF white paper released
www.horizonsetfs.com/Pdf/Education/Swap_Base

An educational report entitled Swap-based Exchange Traded Funds and written by Savvas Pallaris, released in August 2011, provides an outline of these financial tools relative to ETFs using the traditional cash replication method. Canadian ETFs are the main examples used, and therefore care should be taken when considering tax aspects.

ASX options ready program launched
www.asx.com.au

In August 2011, the ASX launched ASX Options Ready, an education program specifically designed for funds managers interested in trading equity options listed on the ASX. ASX became the first exchange outside of North America to establish a listed equity options market in 1976. Today, ASX lists equity options over the most liquid and highly capitalised Australian companies. In the year ended 30 June 2011, the volume traded for all ASX exchange-traded options (ETOs), including equity options, increased 6.9 per cent compared with the previous year.

Consumer finance

Mortgage Health Check
www.moneysmart.gov.au

ASIC recently launched new resources and tools on its consumer finance website, MoneySmart, to help people avoid mortgage stress.

ASIC held a Mortgage Health Month over September 2011, aimed at encouraging consumers to do the online Mortgage Health Check on the MoneySmart website. The Health Check tells people how they are going with repaying their mortgage and gives them practical steps to take if they have any mortgage issues.

The MoneySmart website also includes an online map to help people in financial difficulty find their nearest financial counsellor. The online map, which was launched on 25 August 2011, shows the locations of 400 financial counselling services across the country and can be searched by town, suburb or postcode. Financial counselling is a free, confidential and independent service funded by the federal government and state and territory governments.

Corporate governance

Private equity governance code launched
www.avcal.com.au

On 7 September 2011, the Australian Private Equity and Venture Capital Association (AVCAL) released its Governance Code for the private equity (PE) industry. The Code of Private Equity Governance has the twin objectives of making the activities of Australia’s PE industry better understood and helping PE fund managers discharge their duties to their various stakeholders.

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