

CRYSTAL BALL GAZING, BLIND FREDDY, AND LOOKING AT THE FUTURE

The world is now in its deepest financial

crisis since :- That observation has prefaced many a speech or article on the current financial “crisis”, however no one seems to be quite clear what the comparison should be. Is it the great depression, the 1987 crash or another event such as the 1974 downturn? Perhaps as a financial crisis it is, to plagiarise Tolstoy’s observation on marriage at the beginning of Anna Karenina, “unhappy in its own way”. As so often happens there are those who claim that to the well known seer and sage of the ages “Blind Freddy” “the future was crystal clear; and that what has happened was readily predictable, (at least it seems so in retrospect). However like unhappy marriages, which are all unhappy in their own way, this crisis developed (and may still be developing) in its own way and what happened is now only becoming clear in retrospect as more information becomes available.



If enough doom is preached often enough there is a good chance that some of it may come true. However the very fact that we search for comparisons from the past demonstrates that there have been many past economic crises which were overcome. Since this crisis is characterised by the fact that this is the biggest market fall ever from the highest stock market index ever, this alone should serve to demonstrate that it, like the crises of the past, will also pass. The unknowns are when, where and why will this occur. As we have written before, in this period of uncertainty you must beware of pessimism taking the place of objectivity. It is not a matter of whether the glass is half full or half empty that is a statement of temperament rather than a statement of fact. The objective view is whether or not there is a half glass. That is the fact. How that fact is understood is where a pessimistic or optimistic world view comes into play. These periods of uncertainty and economic downturn have appeared before and have just as readily passed. Harold Wilson once observed that “a week is a long time in politics”, however a year, or even two years, is a relatively short time in economic terms and a very short time when compared to the length of a teaching career or the prospective time to be spent in retirement. Patience and prudence in investment have always been necessary qualities and the bottom of the last crisis is always the start of the next market boom.

It is therefore important to remain objective about the current economic climate, and the likely economic future of the world, for as is evident from this crisis, the world has never before been so economically interdependent, nor have governments throughout the world acted in such unison to overcome a perceived threat to the economic health of the world.

The article below, our annual New Year assessment of ESS/GSO State Super Schemes aims to inform you about the actual position of your scheme rather than perceived doom and gloom. *This information is general in nature and may not be relevant to your individual circumstances. You should refrain from doing anything in reliance on this information without first obtaining suitable professional advice.*

KNOW YOUR SCHEME: Paysafe has for many years pointed out the strengths of the benefits of the ESS/GSO New and Revised super schemes. The two ESS/GSO Schemes are largely protected from short term market negativity. Although all investment is, and should be a long term process, because of its trust deed the ESS/GSO Revised Scheme must always give a positive return ie. your contributions plus interest lump sum cannot have a negative return. However this does not preclude it from short periods where its crediting, or earning rate, may be 0%. The averaged rate for the year must be positive even if the fund has had negative returns. Thus although the current ESS/GSO crediting rate at the time of writing (March 2009) is 0% previous crediting rates during the financial year have been positive.

In the case of the lump sum retirement benefits of the New Scheme these are defined benefits which are not impacted in any way by the share market.

Similarly the retirement and resignation pension benefits of the Revised Scheme are defined benefits which are not affected by the share market. **It is only the 54/11 resignation lump sum benefit of the Revised Scheme which is in any way impacted by the market and this is minimal.** Your current contributions plus interest balance is the product of a long period of strong markets and cannot be negatively impacted ie. Its balance cannot decline, you will simply earn less on the accumulated balance. For those near 54/11 it will only be the current crediting rate which will impact future growth, it will not impact current capital value and this impact will be marginal.

For most of those with a full service history it is not whether or not they will have a substantial advantage from 54/11 only the relative scale of what that advantage is, analysed both in terms of lump sum and income. It is important that short term negative sentiment does not blind those approaching 54/11 to the long term advantage to be received from this strategy. It is important that you have analysis carried out by long term experienced analysts who have long experience of the scheme and how it operates and who can clearly show the lump sum and income advantages in a clear simple understandable form.

GSO New Scheme Members: In our personal and economic life there are often turbulent periods when the unexpected may happen. It is important that when unexpected events occur that you have as much preparation as possible for them so that you are not thrown off course and are able to deal with these events. This preparation has its best origins in being forearmed with knowledge of what is likely to occur and having the knowledge of how it may be dealt with. In uncertain economic times there is often a tendency to become preoccupied with security in investment. **However in the accumulation period before retirement the single most important investment consideration must be with accumulating the greatest capital possible at the lowest level of risk.**

Retirement is far too important to be left to chance, security must be maximised and uncertainty minimised, every bet must be a winner. For those in the New Scheme the accumulation of a substantial lump sum is the cornerstone for a comfortable retirement. The New Scheme is the key to ensuring that you are a superannuation winner by achieving the maximum guaranteed lump sum and its "numbers" are produced in absolute safety. **This statement is in essence a "Blind Freddy" comment however it has particular relevance for many New Scheme Principals who have been approached to become exempt officers and to become involved with trying to maximise their retirement benefit by use of a "Transition to Retirement Pension".**

HOW DOES THE NEW SCHEME WORK? The GSO New Scheme is a defined benefit lump sum scheme (**designed to peak at age 60**) which **guarantees** to pay a lump sum based on the calculation format -

LUMP SUM = YEARS OF SERVICE X CONTRIBUTION RATE X FAS

Thus this guaranteed sum is underpinned by a rising salary and promotion for the only real variable is Final average salary if the contribution is maximised. If a nil contribution rate is chosen the return will be 8.5% of FAS x years of service. The maximum average contribution rate is 5%. A 5% Contribution = 17.5% x FAS x years of service. The standard increase in salary which may be expected is 3% per annum. However there will be periods like the principal class pay rises of 2001 when the standard pay rises undergo a rapid upward revision with the result that end benefits increased dramatically.

Thus while contributions will have been made at substantially lower superable salaries the pay out is in terms of the average of the aggregate of the last two years salary. Given that typically New Scheme members work longer and are thus likely to have the benefit of both rising salaries and promotion over time, it is surely logical that members will benefit most from a Scheme which guarantees its benefit. Thus security lies in maximising your New Scheme contribution and then letting your salary rises and promotions multiply your benefits.

SHOULD PRIVATE SUPER SUPPLANT THE NEW SCHEME USING A TRANSITION TO RETIREMENT PENSION?

If they are over 55 it is possible for a New Scheme principal to declare themselves an exempt officer and access their New Scheme benefit without resigning from service. This can also be done by those under 55 but they are disadvantaged by the fact that before 55 there is a penalty applied to the benefit if taken before age 55 which will substantially reduce that benefit.

The idea of a "Transition to Retirement Pension" is that it will allow you to access your current benefit for income purposes which will then allow you to maximize contribution to a private super scheme up to a level of \$100,000 per annum. On the surface this may seem alluring, however it is a strategy full of risk, for those in a defined benefit scheme.

Like many financial devices which may confer advantage in accumulation super, it is less appropriate or outright not appropriate for those in a government guaranteed defined benefit scheme. Before 55, the discounting of accumulated value in the New Scheme will severely impact the base lump sum before the inherent investment risks operate. After 55, this impediment is removed and it may be possible to extract some advantage if you are positive that you will retire in 2 years. This is because \$100,000 of contribution will only be possible until the 2011/2012 tax year, so it is a very narrow window of opportunity. In addition the minimum pension which may be taken from a Transition to retirement pension is 4% and a maximum of 10%. Assuming a risk free investment strategy, ie. cash based, it is likely that at best the cash return which may be expected in the next 12 months will be 3%, more likely 2%. Thus the pension will not be self sustaining. Therefore all profit must be in terms of maximizing the salary sacrifice at \$100,000. The net sum saved after contributions tax will be \$85,000 plus minimal earnings. If you are to ensure that your relative income remains stable your income will consist of the residual income after salary sacrifice of \$100,000 (This sum must take into account the 9% that DEECD will contribute within your TRP after you have become an exempt officer) plus the pension income. For most members to maintain their income they will need to draw more than 4% and thus will further diminish their ESS residual benefit. A recent technical example from Asgard (Summer edition pages 26-27) illustrates this point.

Given the published pay scales until May 2011, members know what their future pay rises are and thus may calculate what their future ESS/GSO New Scheme lump sum benefit will be, it is relatively easy to see what would need to be put in place as extra salary sacrifice to produce an equivalent return to a projected transition to retirement pension and additional super model. This would be a largely risk free strategy compared to a transition to retirement strategy. You would retain all of the New Scheme benefits listed below instead of losing them all in the hope of a better outcome instead of following a risk free strategy of remaining in the New Scheme and maximizing salary packaging relative to desired current income. If this transition strategy has been put in place

with market exposure the lump sum will have substantially diminished and all other protection and accumulation benefits will have been lost.

NEW SCHEME PROTECTION BENEFITS:

WHAT HAPPENS IF? DEATH IN SERVICE: If the member dies in service before age 60 the New Scheme provides a lump sum payable to your partner which will be the accrued retirement benefit at your death, the calculation assumes that you would contribute at a 3% rate from your date of death until age 60.

BENEFIT RECIPIENT: The person who will receive this benefit is your partner. A "PARTNER" for the purposes of the benefit is "a domestic partner is a person with whom the person is living as a couple on a genuine domestic basis irrespective of their "genders".

DEPENDANTS: Dependants will receive an indexed pension paid to any dependant child up to age 18, or up to age 25 for a full time student. Eligible children receive a fortnightly pension of 5% of your FAS up to a maximum of 20% of FAS between them. These pensions are indexed yearly for CPI.

NO BENEFICIARIES AT THE TIME OF DEATH: Your estate will receive a refund of contributions plus interest plus (if applicable) a minimum benefit top up amount payable to your estate.

DEATH AFTER RESIGNATION: If the member dies after resignation and before they have received their deferred lump sum, this lump sum is payable to your dependants, or if there are no dependants, to your estate.

DISABLEMENT: In the event of a member having a medical condition which prevents them from continuing in service there is a very generous disability benefit and also a temporary disability benefit for up to two years. If your disability benefit goes into retirement with you it is then treated as a retirement pension and receives the 15% tax offset.

COMMENT: Whilst all courses of action must be carefully scrutinized and should not be undertaken without full advice from an appropriately qualified and experienced advisor it is worth reflecting on past experiences of "too good to be true" opportunities to change how your super scheme operates. The change to the New Scheme from the Revised Scheme in 1994, the opportunity to become an exempt officer at the same time, and the substitution of private super for maximizing your New Scheme contributions are now all seen in retrospect to be "Blind Freddy" situations. While you are in the New Scheme all of your benefits are guaranteed and are free of market risk. Once you are in the market proper as an investor, market risk, ie. your money may diminish rather than grow, becomes a major problem. Thus we would urge that you do not in any way exit your New Scheme benefits without a full and careful analysis from an experienced advisor working to a worst case scenario. If there is any doubt do not give up your guaranteed benefit. However provided that you have maximized your ESS/GSO New Scheme contribution it will be beneficial to judiciously package into private super using an appropriate low cost private super. Contact an experienced financial adviser to discuss this.

MAXIMISING YOUR LUMP SUM: Maximise your contribution to the New Scheme, for it should reward you with a guaranteed return. **You may nominate a new contribution rate for the New Scheme between February 1 and April 30, and August 1 and 31 October** which may be 5% or 7% depending on your particular circumstances. The average rate should always be at least 5% and for those who are able to elect 7% for catch up purposes they should do so immediately. By making sure you contribute at the maximum rate and contribute to ESS/GSO pre tax you will maximize your benefits risk free.

Retirement Age: 55? It is vital to make sure that your contributions to the New Scheme are maximised. It may be less vital in the New Scheme to retire at a specific point. For the purposes of maximising the sum to be received it is best to have had 2 years service at your highest salary

level thus maximising the FAS as the multiplying factor. **Thus most members in the New Scheme will need to expect to work past age 55 and many will probably need to work to age 60. NB. Your superable salary regardless of your substantive salary (see below).**

SALARY PACKAGING: The point at which there is a tax advantage to be derived from packaging private super is now \$34,000. This income point will rise after July 1 2009. This will mean that some people who have been packaging substantial portions of their pre tax income should review the tax efficiency of that packaging and make such changes as are needed. For those contemplating a 54/11 strategy and return to work this means that there may need to be a review of how much may be efficiently packaged. (You must also be mindful of the maximum age based contribution limits, now called concessional contributions cap).

ESS/GSO THE MECHANICS:

KNOW HOW FAS WORKS: The bland explanation usually given of Final Average Salary is that it is the average of your last two years salary. This leads to many misconceptions and, as usual, you are far better off than most people think. First it is the **superable salary** which forms the basis of the FAS calculation. Thus for those on any time fraction less than 100% it is the full superable salary which is used for the calculation of benefit not the diminished fraction salary. Where there is some diminution of benefit this occurs where those on a diminished time fraction will have a diminished service time multiplier ie. two years at .5 only gives an additional one year of super service time.

WHAT IF I GO TO A SMALLER SCHOOL?

The other important thing to know about **superable salary** is that it will always remain at the highest attained superable salary for all benefit and contribution purposes until such time as it is surpassed by promotion or increment. If for any reason you receive a lower salary than the highest attained superable salary, e.g. you take on a smaller school, then for the purposes of ESS/GSO super the highest attained superable salary remains the figure for benefit purposes. Thus you will always receive the maximum benefit possible for retirement, disability and death. This does not hold true for Long Service lump sum payments in lieu of long service, this is calculated using your actual TRP figure and statutory super cost.

Make sure that you know exactly what your benefits will be and plan for when and how you will receive them. Make sure that you maximize your ESS/GSO benefits by pre tax contributions and utilize any monies you do not need for life style in additional salary packaging to use its saving power.

54/11 and Revised Scheme Pensions: The 54/11 strategy has not been affected negatively by recent tax changes rather it has been strengthened for principal class members. Remember that while the ESS/GSO pension is fully taxed it is also fully rebated at 15% (what is now termed a "tax offset"). That is, for every dollar of pension paid you will receive a tax offset of 15 cents. This cancels out the tax until the "transition to tax point" is reached.

The FAS needed to produce a pension greater than the "transition to tax point" has been raised to approximately \$107,000 and will be raised further after July 2009. Thus in terms of the TRP range which will produce an FAS of this scale this will occur for those principals at the top of range four in the May 2008 salary translation. Thus for most principals who opt to utilise a 54/11 strategy the tax they will pay on the ESS/GSO pension component may be negligible or non existent.

Over the age of 60 all ESS/GSO pensions are entirely tax free and tax exempt. Thus, the existing 54/11 strategy has become even more attractive and the impact of this tax change is to elevate to age 60 (for most people) the minimum additional years required to break even with a 54/11 benefit (The caveat must be that this will depend on individual service records and circumstances and an appropriate analysis from a suitably qualified and experienced adviser should be sought before

contemplating any course of action in this area). The taxation advice given here is provided as a guide only. If in doubt, seek independent tax advice from a qualified tax adviser.

OVERVIEW: The article opened with reference to the current economic environment and looked at the tendency for short term negativity to overwhelm objective judgement. It pointed out that although much is seen to be self evident in retrospect ,”Blind Freddy “ does not predict the future except retrospectively. If an objective view is used and the experience of the past utilised, then it is clear that both New and Revised Scheme members are very well served by their schemes and that short term negativity should not blind members to the long term advantages of their schemes . Moreover that in time “Blind Freddy “ will have been able to see that this economic crisis, like those which have happened in the past, will eventually end and markets will return to positive returns.

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