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Manager
Philanthropy and Exemptions Unit
Personal and retirement Income Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir/Mdm,

Response to the Treasury Discussion Paper
Improving the Integrity of Prescribed Private Funds (PPFs)

Macquarie Private Bank (MPB) is a division of Macquarie Group Limited. MPB provides wealth management and investment advice to high net worth family groups. Our advisory relationships give us the unique opportunity to understand the intrinsic and extrinsic motivations of why high net worth family groups choose to be philanthropic and how they fulfil their aspirations.

PPFs have set an important benchmark in private giving. It is a structure intended to encourage private philanthropy, and one that is reasonably easy to establish and operate.

Any improvement to the system should be balanced with the long term charitable direction of the country. We believe that structured private giving plays a crucial role and therefore the impact of any proposed changes must be carefully assessed. Structured private giving should be encouraged through a robust framework that gives confidence and certainty to donors.

We support the response presented by Philanthropy Australia, and would like to provide our input to two specific sections:

- 1a. Required distributions;
- 4a. Restrict PPF investment to only liquid assets.

We welcome the opportunity to participate in this consultation process.

1a Required distributions

We support the proposal to replace accumulation plans with a system that would require PPFs to distribute a minimum amount in a given year. We believe that this will add clarity, simplify and improve the administration of PPFs.

Our clients establish PPFs because they have a genuine believe that they can make a difference. They wish to provide financial support to causes or organisations that they believe in. A PPF is a good vehicle to formalise a structure to create an endowment fund to enhance this philanthropic intentions. Frequently, our clients participate in charitable organisations as directors, volunteers, fund raisers or donors.

Setting a minimum rate will always be a challenge. If the distribution rate is too low, the philanthropic motivation of establishing a PPF becomes questionable. If the distribution rate is too high, direct charitable donations may become more desirable than structured giving through PPFs.

What is a reasonable assumed rate of investment return for PPFs? Trustees of PPFs ultimately decide on what is best for their PPF. Investment strategies vary between PPFs, leading to different investment outcomes. However, we believe that most trustees do choose to invest beyond cash, and therefore, a starting point for assuming any investment return ought to be a 'safe haven' rate. A commonly used proxy of a long term risk free rate of return is a government bond or equivalent index such as the UBS Bond Composite Index. We suggest that a reasonable long run average of this rate is around 6% per annum.

Investors ought to expect their investment returns to be above this safe haven rate when investing. If we use an industry benchmark such as an index of diversified funds[1], the average annual return for the past 20 years is 7.55% (to 30 November 2008). It is therefore reasonable to expect PPFs that invest in a diversified portfolio of securities, funds and instruments to return anywhere from 6% to 10% over the long term.

Research by the Australian Centre for Philanthropy and Nonprofit Studies suggests that a total of $1.2bn has been donated to PPFs as of 30/06/2007, with $117m distributed to DGRs in that year.[2] On this basis, average distributions from PPFs represent 10% of PPF funds. This figure is fluid (as grants and donations fluctuate over time) but it does provide a reference point.

An average diversified portfolio that generates 8% and distributes 10% annually will be drawn to around $500,000 (today's value) in less than 25 years. On the other hand, the proposed minimum distribution rate of 15% will lead to the same PPF being drawn to below $500,000 (today's value) in less than half of that timeframe, or 12 years.

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[1] Morningstar Australia Multisector Trust Balanced Index
[2] http://www.bus.qut.edu.au/research/cpns/documents/2008_6_PPFs_Final_Web.pdf.

Table 1 below shows the approximate time taken for an average PPF with a size of $2m to be drawn to less than $500,000 (today's value[3]) using various annual returns and distribution rates. We have used $500,000 as a reference point where PPF trustees may start considering winding up their structures due to potential cost inefficiencies.

Dist. / Return	5%	10%	15%
5%	43 years	16 years	10 years
10%	[illegible]	35 years	15 years
15%	[illegible]	[illegible]	27 years

(Table 1)

Whilst we agree with the statement that "PPFs should neither be prolonged accumulators of funds, nor sparse distributors of fund", we believe it is possible to balance the need with continuing encouragement of private philanthropic giving through PPFs.

Our experience suggests that potential donors are unlikely to consider establishing a philanthropic vehicle with a limited lifespan, and we suggest that a vehicle with an effective life of 12 or 15 years will be viewed unfavourably by potential donors, with the likely result being fewer or no new PPFs being establish in the future.

A shorter lifespan will also have significant negative effect on the potential cumulative distributions over time, thereby hindering the philanthropic intentions of the donor and benefits to society at large.

Moreover, this shorter investment time horizon may be affected by higher market volatility, as recent investment markets have demonstrated. By setting a high distribution rate, Treasury is inadvertently directing PPFs what their broad investment strategy ought to be. In order to achieve the liquidity parameters necessary to distribute 15% per annum, a prudent trustee is likely to invest solely in cash, bonds and a relatively smaller proportion in listed instruments (or funds investing in these instruments).

We believe that all trustees, including trustees for PPFs, already have fiduciary obligations based on the relevant trust laws to formulate the appropriate investment approach for their trusts. A high distribution rate will add an unnecessary burden to the formulation of an appropriate investment approach for PPFs.

We support Philanthropy Australia's recommendation of a 5% minimum distribution rate based on the value of total assets to be distributed in the next financial year. Furthermore, we believe that using a standard rate across the board will help reduce complexity and eliminates the need to apply a separate, lower minimum rate to newly established PPFs. This also means that the Commissioner of Taxation should not have the ability to modify the minimum amount.

[3] Assuming an inflation rate of 3%.

4a. Restrict PPF investment to only liquid assets

We do not believe it to be necessary or appropriate to restrict PPFs to only liquid investments.

Trustees of PPFs have moral and social responsibilities in addition to their legal obligation to ensure prudent management of their funds. These obligations are encapsulated into the various trustee laws around the country, where trustees are required to take into account numerous factors before undertaking an investment.

Illiquid assets may include investment properties, leases, private equity funds that usually have a fund life of around 10 years, traditional equity funds or hedge funds with lock-up periods – in other words, assets spanning all asset classes in the investment universe.

The proposal therefore requires a definition of liquid (or illiquid) investments. Liquidity is a function of a number of factors, most important being time horizon, pricing and market. Some investments may be restricted or locked up for a period of time where investors are not allowed to sell the particular investment. Alternatively, a premium (or discount) may be imposed on the exit price, effectively dampening the desire for someone to exit such investment. It is also possible that an investment may not have such restrictions or disincentive, but there is simply not a buyer. Some investment funds may also impose a redemption gate and liquidity only becomes an issue when triggered in the future, not when the investment decision was made (for example, recent issues surrounding mortgage funds). Hence, we urge caution in defining what liquidity actually means, and any definition should address the different aspects mentioned above.

We believe that with appropriate advice, PPF trustees should be in a position to make educated decisions when investing without any such restrictions.

Illiquid investments are sometimes desirable. From an investment perspective, illiquidity suggests a premium to compensate for giving up short term access. The experience of successful endowment funds in the U.S. indicates that illiquid markets such as private equity, hedge funds and real estate are often less efficient, providing opportunities for the portfolio to extract additional value.[4] Illiquid assets can also add discipline to the portfolio construction, potentially reducing investment churning.

Table 2 in the following page shows the Sharpe ratios of a traditional portfolio (composed of cash, equity and bond) combined with various allocations to other asset classes (i.e., private equity, hedge funds and property trusts).[5] Sharpe ratio is a study of additional return over the risk free rate per unit of risk or volatility.

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[4] The Yale Endowment Update 2007, http://www.yale.edu/investments/Yale_Endowment_07.pdf

[5] Based on quarterly data over the past 80 years and a risk-free return of 6% per annum. Data is extrapolated where not available for the full time period. Further data available on request.

% of Illiquid assets	0%	10% PE	10% PE, 5% hedge funds	10% PE, 5% hedge funds, 5% property	15% PE, 5% hedge funds, 5% property
Sharpe Ratio	0.46	0.56	0.58	0.59	0.64

(Table 2)

The introduction of illiquid assets into a portfolio clearly offers greater return potential and lower volatility due to their illiquidity premium and diversifying power.

From a risk adjusted return perspective, our internal research suggests an investment portfolio may benefit from allocating up to 30% of its assets to less liquid assets. This is not to suggest a 30% allocation to illiquid assets for PPFs, but it serves to highlight the potential value of less liquid investments in constructing an investment portfolio.

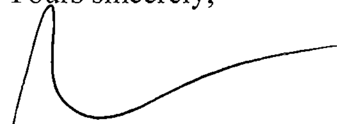
Trustees should have the opportunity to make investment decisions for the funds that they are entrusted with. Restricting PPF investments to only liquid asset will not address the issue of inexperience or ignorance of a trustee's obligation. Given that liquidity and investment obligations are already enshrined in various trustee laws, we believe that a blanket restriction is unnecessarily punitive.

An alternate approach can be found in s52 of the *Superannuation (Industry) Supervision Act* 1993. Superannuation funds are required to formulate investment strategies in accordance with a number of legislated guidelines under s52, Similar guidelines may be legislated for PPFs to ensure that PPF trustees take into account of liquidity, transparency and potential cashflow issues. This will effectively require a trustee to match its assets appropriately towards its cashflow need, and may also introduce some consistencies between ATO's role in regulating self managed superannuation funds and PPFs.

We hope that our submission is of assistance to the Government and Treasury in deliberating the number of issues raised in the discussion paper.

Please do not hesitate to contact myself on 02 8237 7700 or francis.tan@macquarie.com if you require further clarification on this submission.

Yours sincerely,



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