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your **money** your **future**

FINANCIAL PLANNING NEWSLETTER

A familiar face offers valuable advice

Baby Boomer John, 65, looks back on a lifetime of financial decisions to provide some valuable tips to future generations.

Remember when you spent a small fortune on that trip to Hobart after the Wrest Point Casino opened? The holiday pay lasted barely one hour on those roulette tables! Four decades on and I'm pleased to report that trip didn't set you on a path to financial ruin.

Without completely giving the game away, let me share some of what's happened to our world over the past 40 years. Firstly, you survived! Those teenage years didn't cause any irreparable damage although your knees and hips are paying the price for your Kamikaze approach to footy.

Our country has flourished – almost twice as many people call Australia home today than in 1973, most people earn in a month what you earnt in a year, and the average price of a house and land package in the early 70s (approximately $20,000) wouldn't cover the deposit of an average home loan.

Many of the headlines you read in the morning paper in 1973 are just as relevant today – "Crisis in the Middle East", "Prime Minister Under Pressure" and "Petrol Prices Soar".

It's a similar story when it comes to finances. The fundamentals of 1973 remain the same today, but as you think about the future, let me share some of the wisdom I've gathered over the past 40 years:

Live within your means: This seems fairly obvious but credit facilities will become easier to access as you enter your 30s. Even your grandkids have credit cards! Cleaning up the mess of easy credit debt can put your long-term plans back many years.

Minimise debt: The loan from your father to buy that mint-condition Ford Falcon GTHO may have made sense at the time but it would drag on for years before you paid it off. And let's not even start on the financial commitment to purchase that first colour TV in 1977! Keep your debt to a minimum and make paying it off a priority.

Develop a savings plan: Remember the old State Bank savings book for which Nanna would give you 20¢ to deposit each week? It was the one successful financial decision made for you in the first 20 years of your life. Consider the money that goes into a savings account an essential part of your budget. There'll be plenty of rainy days, and any leftover will provide a solid foundation for that retirement nest egg.

Start investing: Don't expect me to share the previous 40 winners of the Melbourne Cup or share tips that could make you a billionaire. Start to think about how best to invest those savings – the earlier you start, the more you'll have when you retire. Don't forget to manage the risk too. It's ok to put some in shares, but also look to spread it around via term deposits, property or managed funds.

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A familiar face offers valuable advice continued

Protect what's most important: "Life insurance? What do I need life insurance for?" It may seem far-fetched now but insurance will pay for itself many times over. Hospital expenses, the odd minor car crash and a couple of 'life episodes' are sure to arise; when they do the peace of mind provided by insurance is invaluable. Speaking of health, stay out of the sun and watch that expanding waistline and try to lay off the bacon and eggs once in a while!

Establish credit: It is vitally important to start establishing credit while in your 20s. A clean credit report will make life much easier in the future, especially when your partner starts dropping hints that she'd much prefer to send Junior 1 and Junior 2 to the local Grammar School and you'll need a loan to get started. And let's not even start on Junior 3, 4, 5 etc … just kidding!

Choose your life partner carefully: Yes, you'll meet a nice girl or boy and settle down, but it'll be touch and go there for a while. For plenty of the boys from your school years, things won't end quite as happily. While you don't have to see eye to eye on every financial issue, someone with similar goals and values as you will make life much easier. If you plan on combining your finances with your spouse, communication and honesty are especially important.

One last tip – enjoy life! Money is supposed to be used, in part, for your enjoyment. Travel, entertain, take some regular golf trips, splurge here and there; you can do it all. But don't wait. Life is here and now, and you'll be amazed how quickly the next 40 years will fly by.

Good luck!

Making a change for the better

Self-managed superannuation fund trustees may covet the control and investment flexibility they have to provide for their retirement, but it is using it to their advantage that really counts.

According to the latest **Intimate with Self-Managed Superannuation** research report from Russell Investments, less than half of retired trustees indicated they had changed, or were planning to change, their asset allocation in retirement.[1]

This is despite the investment objectives being considerably different as SMSFs move from the accumulation phase into the pension phase.

One ongoing concern is that some SMSF trustees may simply be moving an existing portfolio from growth assets to defensive assets, such as cash and term deposits, without fully understanding the implications.

With more people living longer in retirement, most investment portfolios need a portion of growth assets, such as dividend-paying equities, to generate sufficient income for the trustees to live the type of retirement lifestyle they have planned.[2]

SMSFs have traditionally held a high percentage of their portfolio in cash and term deposits and 2012 was no exception.[3] According to the Russell report, trustees allocated 33.9 per cent of their SMSF investments to cash and term deposits in 2012, compared to 25.6 per cent in 2011.

While trustees may be de-risking their portfolio by investing in cash, the impact of inflation means they may also run the risk of running out of money in retirement earlier than anticipated.

With the help of a financial adviser, SMSF trustees can get a clearer picture of what the appropriate investment strategy for their fund may be in the lead up to and in the retirement phase, without giving up their control.

Confirmation of SMSFs' desire for control of their superannuation and investment decisions was evident in the Russell report, however SMSFs' lack of portfolio diversification may mean trustees' research is failing to identify opportunities for accessing all of the available asset classes.

With a growing number of SMSF trustees approaching retirement, 64 per cent of trustees said they were at least reasonably confident they were on track to achieve their retirement goals. However, this means about 36 per cent of trustees may fall short.[4]

Making the most of your SMSF means regularly reviewing your investment strategy in line with your lifestyle goals. As these goals change over time, it's important to work with your financial adviser to make the appropriate changes to your investment strategy. Doing this early is the best way to ensure your retirement goals are met.

1 'Intimate with Self-Managed Superannuation', Russell Investments, 2013, viewed 26 March 2013, http://www.russell.com/AU/_pdfs/market-reports/spaa/R_EVE_SPAA_Report_V1FF_WEB_1301.pdf

2 Wealth Professional, 2013, viewed 23 March 2013, http://www.wealthprofessional.com.au/article/smsf-clients-need-more-growth-assets-173239.aspx

3 Australian Tax Office, 2013, viewed 23 March 2013, http://www.ato.gov.au/superfunds/content.aspx?menuid=49150&doc=/content/00332225.htm&page=8&H8

4 'Intimate with Self-Managed Superannuation', Russell Investments, 2013, viewed 26 March 2013, http://www.russell.com/AU/_pdfs/market-reports/spaa/R_EVE_SPAA_Report_V1FF_WEB_1301.pdf

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Searching for yield

Forget the search for El Dorado; investors these days are looking for something more tangible. They want the certainty of cash in the hand at better rates than those on offer at the bank, but after the turmoil of recent years they also value security.

With the cash rate at a record low around 3 per cent and term deposit rates below 4 per cent, investors must look elsewhere for a decent yield from the fixed-interest portion of their portfolio, and that is where bonds fit in.

Put simply, a bond is a loan provided by you, the investor, to the issuer who may be a government, a company or other body. The bond issuer promises to make interest payments, called the coupon, and repay the principal at specified dates.

People buy bonds for income and the security of knowing they will get their money back in full if they hold onto their investment until maturity. Of course the higher the quality of the bond (eg. AAA rating), the lower the yield and the lower the chance of default. Unlike a term deposit, bonds can be bought and sold on the secondary market. This provides bondholders with the opportunity to make capital gains to boost the total return from their investment.

There is an inverse relationship between the value of a bond and interest rates. If interest rates fall, the value of your bond will increase because it pays a fixed rate of interest based on its face value. If interest rates rise, the market value of your bond will fall but you still recoup your initial investment if you hold to maturity.

There are many kinds of bonds but government bonds are the standard against which most fixed-interest investments measure themselves in terms of both risk and return.

Government bonds

Commonwealth bonds are issued and guaranteed by the federal government while semi-government bonds are issued by state governments, to finance infrastructure and other spending programs. You can also buy bonds issued by local government authorities and government-guaranteed authorities like Telstra.

Most government bonds pay a fixed coupon rate but you can also buy inflation-linked bonds where returns are adjusted for inflation over the life of the bond.

Top ranking government bonds are AAA-rated and the coupon reflects that. Although it must be stressed we are talking here about bonds issued by the likes of Australia or the US, not Greece or Spain. The higher the credit rating, the safer the investment and the lower the interest rate needed to attract investors.

In recent times Australian Government 10-year bonds have paid interest of about 3.5 per cent. That is not much of an incentive to invest for 10 years, but foreign investors have been lapping them up because Australia is regarded as a safe haven, albeit with a high Australian dollar. Not only that, but 10-year US Treasury bonds pay interest of just 2 per cent and shorter-term US bonds pay close to zero.

If you want to earn a better return on your fixed-interest investments, you need to turn to the corporate sector.

Corporate bonds

Corporate bonds are issued by companies at fixed or floating rates of interest where the coupon rate varies in line with some market indicator. They are higher risk than top-rated government bonds so quality is the key. This is because the promise to pay regular income and repay your capital depends on the creditworthiness of the company and the quality of its assets.

In other words, there are no capital or income guarantees with corporate bonds. Even so, they are less risky than shares. If a company fails, bondholders will get their money back before shareholders.

As experienced investors know, there are rewards for accepting some level of risk. The challenge is to make sure that you understand the risks and that you are being adequately rewarded.

For example, when BHP Billiton launched a $1 billion bond issue last year it was snapped up by investors, despite offering a coupon of just 3.75 per cent[1]. The reason for this was the perceived safety of the investment by the market. But you can also find bonds issued by smaller listed companies, which are well known and well run, offering coupons of up to 7 per cent.

A balancing act

Used wisely, bonds are designed as an income diversifier, providing some protection for your investment portfolio from market downturns. While they may be boring, they can also be complex so you may need professional advice to select the right investment mix.

Bonds do their job best when you hold different types of securities with different risk and return profiles to minimise any losses. It also means selecting bonds with different maturities to protect against adverse interest rate movements.

Most people will find it easier to achieve the necessary diversification with a bond fund where professional managers buy and sell bonds for capital gains as well as income. Then you can sit back and enjoy a regular income without sacrificing safety.

1 Jonathan Shapiro, ‘Big Australian boosts local bond market’, The Sydney Morning Herald, 10 Oct 2012

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Investor confidence grows with market

After several years in their bunkers, Australian investors are beginning to look beyond the safe haven of cash in the search for better returns. Shares have started the year with strong gains, the residential property market is showing signs of recovery and superannuation fund returns are the healthiest in years.

Suddenly, growth is back on the agenda and it is not hard to see why. Interest rates for bank term deposits have fallen below 4 per cent, less than the dividend yield on bank shares. And unlike shares and property, bank deposits offer little opportunity for capital growth.

Experienced investors know that long-term wealth accumulation depends on total investment returns from income and capital gains to keep ahead of inflation.

Over the past 20 years, shares and residential property have provided a total return of about 9 per cent a year[1]. Roughly two-thirds of that return comes from capital gains, but the income from quality shares and property also rises over time. By comparison, interest rates on term deposits fluctuate depending on the interest rate cycle.

Time to think long-term

Now that the pendulum is swinging back towards growth, it is a good time to check whether your investments are on track to deliver the returns you need to reach your long-term savings and lifestyle goals. The place to start is at the finish line.

No matter what your age or stage of life, the ultimate goal is a long and comfortable retirement and that takes some planning. Everyone's aspirations and circumstances in retirement will be different. First you need to think about the lifestyle you hope to lead in retirement and what that would cost.

As a general rule-of-thumb, advisers suggest you will need about 65 per cent of your pre-retirement income to maintain your current standard of living in retirement, assuming you retire at age 65.

As a starting point, the Association of Superannuation Funds of Australia (ASFA) estimates that a single retiree needs $41,000 a year and a couple needs $56,000 a year to lead an active and comfortable lifestyle[2]. This includes things such as private health insurance, a reasonable car, domestic travel and the occasional overseas trip. A more modest lifestyle costs less, but more than the Age Pension currently provides.

The next step is to work out the savings needed to achieve your goal. Most people focus on the amount they need to accumulate by the time they retire, but that is only part of the equation. The retirement lump sum you need to aim for will depend in part on the return you earn on your savings after you retire.

Growth boosts retirement income

Take the example of a single person retiring at age 65 and aiming for a comfortable lifestyle on $41,000 a year. If their savings are invested for a return of 5 per cent a year in retirement they will need a lump sum of $765,000; but if they earn a 7 per cent return they will need only $630,000. The lump sum required by a couple aiming for $56,000 a year would be $1 million with a 5 per cent return and $865,000 with a 7 per cent return.

In other words, if you invest your entire nest egg in conservative cash and fixed interest investments you will need a much larger lump sum on retirement than you would if you left some of your money in growth investments such as shares and property. Either that, or resign yourself to living on less.

A question of balance

While it is prudent to reduce exposure to higher-risk growth assets as you near retirement, that does not mean excluding them entirely. Getting the mix right is a balancing act. Your adviser will be able to help you work out the best mix of growth and income investments to fit your life stage and risk tolerance.

According to the Australian Bureau of Statistics, the average 65-year-old Australian can expect to live another 19 years if they are male and 22 years if they are female[4]. That is a long time to be living on your savings, especially when you consider that the average retirement age is actually closer to 55, not 65[5].

Saving for retirement does not stop at age 55 or 65, it is a life journey. By maintaining an appropriate balance of growth and income investments your savings will continue to work hard while you take it easy in retirement.

1 Russell Investments, ASX, Long-term Investing Report 2012, viewed 22 March 2013, http://www.russell.com/AU/_pdfs/market-reports/asx/ASX_Report_2012.pdf

2 ASFA Retirement Standard, February 2013, viewed 22 March, 2013, http://www.superannuation.asn.au/resources/retirement-standard

3 SuperGuide, viewed 22 March, 2013, http://www.superguide.com.au/how-super-works/a-comfortable-retirement-how-much-super-is-enough

4 ABS, viewed 22 March, 2013, http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/4125.0main+features3110Jan%202013

5 ABS, viewed 22 March, 2013, http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/6238.0Main%20Features3July%202010%20to%20June%202011?opendocument&tabname=Summary&prodno=6238.0&issue=July%202010%20to%20June%202011&num=&view

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