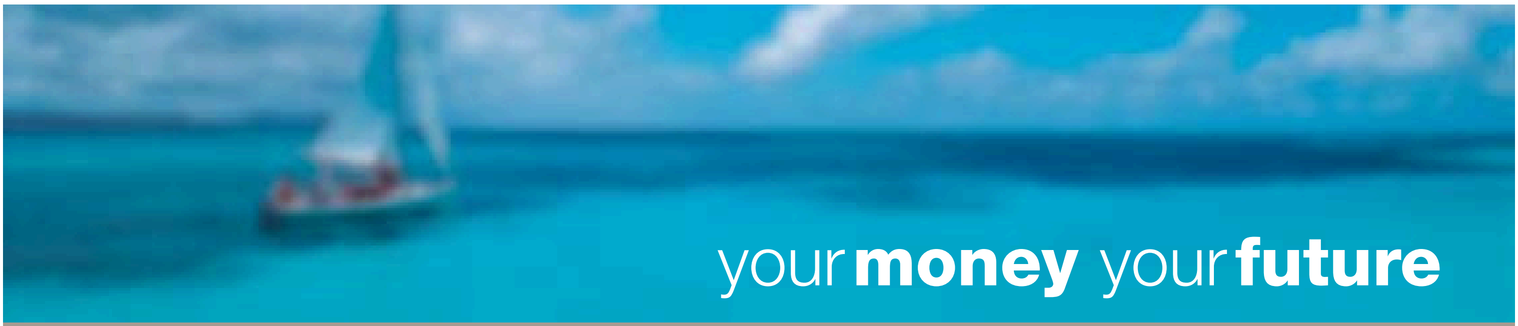

FINANCIAL PLANNING NEWSLETTER

Demystifying risk

The term ‘risk tolerance’ is at the centre of things when it comes to making investment decisions. But what does the term really mean? Is it possible to pin it down so we understand it better, and understand the role it plays in our investment decisions?

Researchers into human behaviour and finance like David R Hunter have taken a closer look.[1] One way we can share their insights is to put down a few statements about risk – some might call them ‘myths’ – and then look more closely at each statement so we can understand what the research really shows.[2]

My risk tolerance is high in the good times. But when the markets drop back, so does my risk tolerance.

In fact, according to Hunter, our risk tolerance does not change; it is our **perception** of risk that changes. He describes risk perception as the rational process we follow in making an assessment, whereas risk tolerance is more of a personality trait.

We might agree that a Formula One driver like Mark Webber has a high risk tolerance for speed. If he drives at 270 km/hr in the straight but drops back to 90 km/hr to take a bend, does that mean his risk tolerance is higher in the straight than it is on a bend? No, his risk tolerance is constant, but his perception of the amount of risk changes; that’s why he reduces speed.

My risk tolerance determines how I allocate my assets. And ultimately it determines whether I’ll meet my investment objectives.

To sort out the relationship between risk and asset allocation, Hunter says it helps to take a closer look at three components of risk.

Risk **required** is the first of these. This is a financial characteristic which describes the risk you need to take on to achieve your financial goals.

Risk **capacity** is also a financial characteristic, describing the flexibility built into a financial plan. Put another way, it’s about the answer to this question: How much downside can you cope with before your plans are off track?

Finally, there is risk **tolerance**. This personality trait describes the level of risk an investor prefers to take.

Asset allocation depends on all three of these risk components. The task for the investor, with their financial adviser’s guidance, is to find the right balance.

I love bungee jumping and abseiling from skyscrapers; therefore I exhibit a high risk tolerance in my investment decisions.

No, this is not what the research shows, according to Hunter. He says there are four types of risk tolerance – physical, social, ethical and financial. In practice, we all behave consistently **within** a risk

1 David R Hunter, ‘Risk Perception and Risk Tolerance in Aircraft Pilots’, http://www.equinox.co.za/article_2771.html

2 Hunter, ibid

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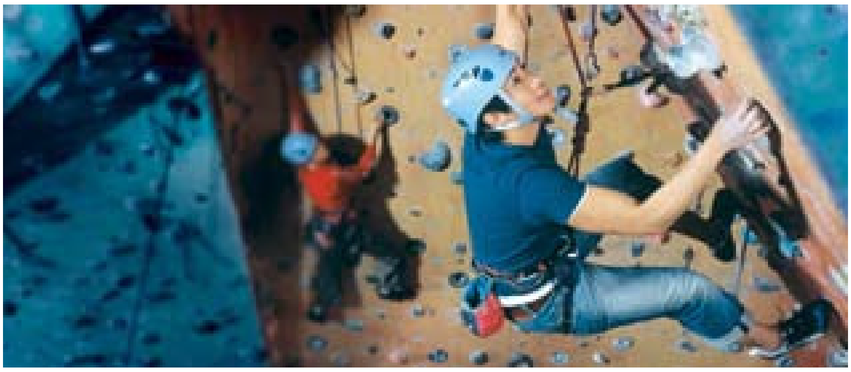
Demystifying risk continued

tolerance type (eg. physical), but not across these types.

If you love abseiling on weekends you clearly have a high physical risk tolerance, but you may have quite low investment risk tolerance. Being a Mark Webber doesn't make you into a daring investor.

When it comes to **financial** risk tolerance, research shows that it has no sub types. In other words, your risk tolerance is the same for insurance, for investments, and for borrowing.



It is possible to estimate my risk tolerance without working with my financial adviser.

Yes, and no, says Hunter. Yes, because the research shows that an investor's self-estimate of risk tolerance is often better than an adviser's estimate – when that is just based on an interview with you. But no, because a well-designed and delivered risk tolerance questionnaire, provided by your financial adviser, should give a better outcome.

As with all questionnaires, it is important to eliminate any bias which can lead to over- or under-estimation of risk tolerance. Getting that estimate right is important so that each investor is comfortable with their investments at each stage through the normal market cycle.

My risk tolerance is determined by key factors such as my age, my time horizon, and my retirement plans.

Hunter says that while factors like time horizon are relevant to investment advice, they are not relevant to assessing risk tolerance. This is not to play down their importance; it is simply to recognise that they are not 'in the mix' when you are assessing risk tolerance.

This means it is important to put aside these issues when looking at your risk tolerance. Once that is sorted out and it is time to move on to specific investment advice, then it is time to consider key factors like age, plans and time horizon.

Knowing your risk tolerance

If you and your adviser have a clear idea of your risk tolerance – or any other factors that affect good decision-making – that gives you a really solid platform for an effective financial plan.

Covering your bases

Is 'cheap' necessarily cheerful?

Television commercials abound which offer quick and easy insurance cover. But how good is the cover they offer?

It could be argued that the cheaper the policy and the less rigorous the application, the greater the chance you will be disappointed should you ever have to make a claim. It's not that the policy isn't necessarily good enough in its own right, it's rather that a generic off-the-shelf policy isn't tailored to your needs and could easily miss the mark.

For example, a life insurance policy without a medical examination may be simpler but typically it's also likely to cost more, and deliver less. It makes commercial sense when you think about it. If the insurer does not know your medical history, they need to cover themselves against all eventualities.

And so do you. That's why you should look at the entire suite of life products (life, total and permanent disability, trauma and income protection), so you know you are properly insured should you be unable to earn an income and provide for your family. After all, your ability to earn is your most important asset.

According to the Financial Services Council's website Lifewise, a 25 year old male has a lifetime income potential of $4.1 million.[1] If you suddenly find you can't work, then that's an awful lot of money to be foregoing. The disability support pension falls well short of the income potential amount, so it's a sound argument for making sure you have effective and adequate policies in place.

Looking at the whole package

There is a range of insurers out there advertising different policies, each with different levels of cover, and different exclusions and inclusions.

As a result you need to do your homework and make sure you have the right combination of policies to meet the needs of you and your family.

And that's where a professional financial adviser comes in. Rather than taking out various policies piecemeal, an adviser can look at your life situation holistically and provide a solution through fully underwritten policies designed specifically to meet your needs. By looking at the whole picture you can also consider the coverage you may have under your superannuation, and what you need to fill in the gaps.

Perhaps now is a good time to talk with us about the right insurance cover for you.

1 http://www.lifewise.org.au/do-i-need-insurance/your-income,-your-greatest-asset.aspx

Coming to grips with carbon emissions

Like the GST before it, the introduction of a carbon tax from 1 July 2012 now seems inevitable. So, if you're going to have to pay it, how can you live with it successfully, and possibly profit from it?

Impact on our pockets

The overseas models are reassuring. Carbon taxes are well established in many countries including Denmark, Sweden, the UK and the Netherlands. Each of these countries has packaged its carbon emissions regime with its own balance of charges, rebates, trade-offs and offsets, making it difficult to compare the outcomes. A 2010 survey reported that the introduction of the carbon tax had had negligible impact on the economies of the European countries which introduced it between 1994 and 2004[1]. More recently, a May 2011 report commissioned by General Electric concluded that it is possible for economies to reduce carbon emissions while maintaining economic growth.[2]

Even though motor fuel is exempt and the government has announced compensation for 70 per cent of households, the tax will affect some individual tax payers as prices rise, depending on what they consume, and how much of it. Household compensation is designed to meet predicted cost of living increases flowing from the tax of an estimated $10 per family per week at the supermarket checkout.[3]

However, it seems that the tax will have minimal impact on the investment strategies of those saving for superannuation and approaching retirement. The Investor Group On Climate Change, which includes the chief executives of Australia's largest superannuation funds have rebuffed criticism that a carbon tax would leave them unable to compete with overseas rivals and they predict it will have little negative effect on their performance.[4]

Impact in our economy

There is no doubt that the new carbon tax will impact on the economy, even though diesel and petrol are not affected, and Australian export industries such as the steel industry will be compensated to ensure that their pricing remains competitive in overseas markets. The new tax will be paid by the 500 heaviest producers and consumers of emissions produced by burning carbon fuels, including every coal-based electricity generator, and this extra cost will inevitably be passed on to end users. As a result, most businesses will be exposed to it in the form of higher energy bills, or pay it as part of the price of products and components manufactured using carbon-based energy.

This, of course, is the central point of the tax – commercial energy producers and users, obliged to factor the tax into their business plans, will adopt strategies to minimise environmental impacts, thus reducing both their carbon tax liability and greenhouse emissions. The new tax should stimulate industry to seek cost-effective replacements for carbon energy or less carbon-hungry power sources. This pressure on industry to cut carbon use will only increase, since the tax rate will be increased annually to achieve greenhouse reduction targets.

New opportunities

Non carbon-based power sources such as solar energy and wind farms, environmentally advantaged power generation from sources like landfill gas, and new technology such as improved solar energy panels, should become sought-after investment prospects in the near future. Airlines, for example, are planning to partly replace crude oil as a source of aviation fuel, with Virgin investing in technology to convert eucalyptus oil into aviation fuel, while Qantas is investigating production of aviation fuel from green waste and garbage.

Companies which effectively cut their expenditure on carbon tax permits or introduce lower carbon technologies will attract the attention of venture capitalists, shareholders and fund managers. For many, the real financial incentive will come with the promised transition to emission trading in 2015. Emission trading schemes are already in place in 32 countries and converting carbon emissions to a tradeable commodity in Australia could transform energy credits earned through carbon efficiency into a viable exportable product.

Australia's carbon future: The ins and outs[5]

- Starts on 1 July 2012, at a rate of $23 per tonne, rising annually by 2.5 per cent in real terms. Transition to an emissions trading scheme from July 1, 2015 means that the market then sets the price.
- Affects around 500 companies, the largest producers of carbon emissions. They pay the tax and will pass costs on to their business customers.
- Compensates around 70 per cent of households fully for cost of living increases; a further 20 per cent of households are partly compensated.
- Imposes no new tax on household and commercial diesel fuel and petrol.
- Gives assistance to conventional electricity generators to convert to cleaner technologies.
- Introduces a new $1.2 billion Clean Technology Program to improve energy efficiency in manufacturing and support research into low pollution technologies.
- Assists emissions-intensive businesses with a $9.4 billion program, to offset exposure to competition from countries without a comparable carbon price.

1 http://sapiens.revues.org/1072#tocto2n3
2 http://www.ge.com/au/protectingprosperity/
3 SMH, July 11, 2011
4 IGCC: http://www.igcc.org.au/Resources/Documents/Global%20Investor%20Report%20embargoed%20to%20June%2013th.pdf
5 Australia's carbon tax details on tap, Marketwatch, July 8 2011. http://www.marketwatch.com/story/australias-carbon-tax-details-on-tap-2011-07-08?reflink=MW_news_stmp AFR, Monday, 11 Jul 2011, p 8.

Super: 'hands on' or 'hand off'?

Taking the wheel

Control, choice and flexibility are key reasons people give for starting a self-managed super fund (SMSF). There were 447,620 SMSFs in Australia by March 2011 so they clearly have strong appeal. This was a 6.95 per cent increase in 12 months and represents upwards of 5000 new funds established per quarter.[1] With $432.4 billion in assets at March 2011, SMSFs now make up almost one third (31.8 per cent) of total superannuation assets of $1.36 trillion.[2]

By their very nature each SMSF is unique so if this path is for you, it is important you get off to a good start. That means working closely with your financial adviser as they have a unique role in the process.

What is an SMSF?

So what is an SMSF, and why would you want one? It is simply another vehicle you can use to save for retirement but one that must meet certain conditions. For instance, SMSFs must have fewer than five members, all of whom are trustees of the fund. Additionally, no member of the fund can be an employee of another member unless they are related.

As trustee you are legally responsible for running your SMSF according to its trust deed and the relevant laws. The sole purpose of an SMSF is to provide retirement benefits to its fund members so it is critical the SMSF's investments are quite separate from any member's personal or business affairs. If not, you will feel the impact of harsh non-compliance penalties from the Australian Taxation Office (ATO) which supervises SMSFs.

SMSF investments should also not offer any pre-retirement benefit to members. While an SMSF can invest in collectibles like paintings, fund members cannot hang them on the living room wall.

Generally speaking, annual running costs mean a fund needs to have at least $200,000 to be cost effective.

But an SMSF may be right for you, especially if you want to control your investments, choose where you put your money, and enjoy the flexibility of making your own decisions.

Having a co-driver

You can't delegate your role as trustee but you can share some of the regular tasks. Some SMSF trustees want a hands-on approach where they do virtually everything while others prefer to be hands-off, delegating as much as possible. And then there's everything in between.

If you choose to use outside assistance, then the decision is between using a financial adviser, or an accountant or administrator group. The key difference here is that while the accountant or administrator group can provide you with technical back-office functions, it remains your task to determine things like asset allocation and fund strategy.

Having a relationship with an adviser is important if you are looking for strategic and investment advice. But not everybody can give you financial advice. The adviser must hold or be licensed under an Australian Financial Services Licence (AFSL). Consequently while accountants can help establish an SMSF and lodge tax returns, they cannot advise on many superannuation strategies related to SMSFs nor on buying and selling assets.[3]

So when it comes to your SMSF, there is flexibility in the way you can obtain financial advice. Whether it's one-off insurance planning advice, overall strategic advice, or regular investment advice, your adviser can help you manage your SMSF collaboratively, with as much or as little help as you require.

Boosting returns

An SMSF offers important tax advantages. When you make a concessional contribution into the fund, the 15 per cent contributions tax is not deducted immediately as it would be in a wholesale, retail or industry fund. Instead, you can wait until you submit the fund's annual tax return. So the tax on a contribution made in July 2011 may not need to be paid until April 2013. That's 21 months during which those dollars work for you in your SMSF, before you pay the ATO. Add to that the impact of any imputation credits of up to 30 per cent, and it becomes even more tax effective.

In addition SMSFs are an effective estate planning tool as you can tailor the strategy to suit the members' circumstances. A fund can also borrow to purchase property or shares, both of which have the potential to leverage your investments and build your retirement savings.

SMSFs are a great vehicle for those who want greater involvement in their retirement savings. But they do require personal commitment, work and effort. While some things can be outsourced, as the trustee you are responsible for the decisions made in the fund.

1 http://www.ato.gov.au/superfunds/PrintFriendly.aspx?ms=superfunds&doc=/content/00279547.htm

2 ibid.

3 Guidance note for advising on SMSFs page 4 (see attached)

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