your money your future

FINANCIAL PLANNING NEWSLETTER

Parity: but what now?

When the Australian dollar reached parity with the US dollar there was jubilation among some in the media, as if we had won a hard-run race.

Had we? And, if so, where's the prize? Why should we have this sense that we have achieved some holy grail?

The Australian dollar breached parity three times in as many months late in 2010; by New Year it was commonplace. The reasons vary: weakening currencies in the major economies of the US, Europe and Japan; strong commodity prices on the back of demand from Asia, and particularly China; the widening interest rate gap between Australia and other countries whose currencies are also traded frequently.

It's hard for overseas investors not to want to invest in fixed interest here when our rates are around the 6 per cent mark. Offshore rates are significantly lower. While our official rate is 4.75 per cent, the official rates of the US, Europe and Japan are all below 1 per cent.

Monetary easing in the US has kept the greenback under the hammer. The US Federal Reserve introduced its second quantitative easing program (named QE2 but bearing little resemblance to a luxury cruise). This has seen a flood of money onto the US market in a bid to stimulate the economy but there are plenty of doubters who believe it won't work the second time around. Printing money to stimulate national economies has a bleak history.

Another factor bolstering the Australian dollar is that we have displayed solid economic fundamentals, being the only OECD country to come through the 2008/09 crisis without going into recession.

Rebalancing world currencies

Some see the strength in the Aussie currency as merely a rebalancing of world currencies between those countries with high levels of consumption and/or private debt, and those with low debt.

Whatever the reasons, the strong Aussie dollar gives us the opportunity for cheaper travel overseas and to enjoy cheaper electronic equipment, flat screen TVs and cars. Lower prices constrain inflation, which should also help to limit any future interest rate rises as it will keep annual consumer price index (CPI) increases within the Reserve Bank's preferred 2 to 3 per cent range.

Other winners from a high dollar are those businesses reliant on imported materials as they can enjoy the benefits of lower input costs, and industries such as agriculture or mining which require imported machinery.

But can the strength last? Having broken through the $US1 mark, will our dollar drop back? The balance of opinion seems to favour the dollar being around

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Parity: But what now? continued

parity through 2011 – some even think as high as $US1.10 due to the strength of demand for our resources.

Of course it's not good news for everybody. Exporters in particular can feel the chill from the strong currency. One area hurting is tourism; another is higher education with a drop in the number of overseas students wanting to study in Australia, undermining an export industry which earned $18 billion in 2009.

Should you hedge?

To 'hedge' is to take steps to insure against loss. Some resource companies hedge against currency fluctuations, others don't: Rio Tinto hedges, BHP doesn't.

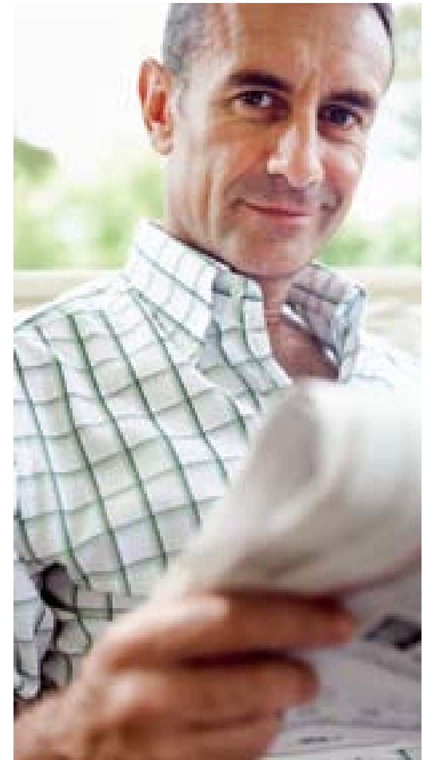
Because the Australian share market represents less than 3% of the world share market (MSCI), many investors seek exposure to iconic international businesses like Microsoft, Toyota or Apple. In doing so, these investors may feel some pain from a strong dollar and wonder if they need to hedge.

If your money is invested overseas there will inevitably be currency risk. Indeed, if the Aussie dollar were to rise enough, any positive returns could well turn south.

Let's take a simple example in Aussie dollars to illustrate the point. Say you had $10,000 invested in US assets with a return after fees of 6 per cent and the dollar was at parity. Your return would be $600. But if the Aussie dollar rose to US$1.05 then the value of your $10,000 capital investment would fall to $9,524 and your $600 becomes $571. So instead of having $10,600, your principal and return is only worth $10,095. Conversely, if the dollar were to fall it would magnify your gain.

There is no right or wrong when determining if it is appropriate to hedge international investments. There is a small cost involved as with any form of insurance. If you don't hedge, swings and roundabouts will inevitably influence the return in the short term but over time the currency impact on your total return will generally even out.

Parity may well be here to stay for at least the short to medium term but as in all races there are winners and losers. If you need any advice on your international investments please don't hesitate to contact our office to discuss your needs.



Aussies remain positive about retirement years

Despite increasing talk about 'longevity' risk and the realisation that people will be living longer lives, Australians generally have a positive, active and responsible attitude towards retirement, according to a global survey on retirement conducted by GfK.

The AXA 2010 Retirement Scope survey revealed an impressive 95 per cent of working Australians saw their retirement years as a period in life they had to prepare for financially. Second only to Canada with 97 per cent and followed by the Czech Republic with 93 per cent, and the UK and Belgium with 92 per cent.

But beyond the need to prepare financially for retirement, working Australians also saw it as a time to dedicate to leisure, new activities and socialising.

Eighty-seven per cent of Australians surveyed saw retirement as a time to take care of themselves and an opportunity to get involved in group projects, while 83 per cent saw it as a time to start or create a new activity. Spending more time with relatives also rated highly, with 78 per cent of respondents agreeing.

Overall Australians were less focussed on the negative aspects of retirement, such as ill health and dependence (38 per cent), and more focussed on positive aspects of retirement, such as getting involved in new activities and having more time to themselves.

In general, the trend across all the countries surveyed was for people to put the greatest emphasis on preparing for retirement, seeing retirement as a time to take care of themselves and a time to spend with family.

If you would like to find out more about the best retirement strategy for you please make an appointment with our office.

Ensuring your future

There is little debate that income protection (IP) insurance is a valuable form of insurance for any working Australian.

How does IP work?

IP pays a monthly benefit, usually equal to a maximum of 75 per cent of gross income, if you are unable to work due to sickness, illness or injury. Your benefit payments commence after an agreed waiting period (usually 30, 60 or 90 days), and continue for the period specified in the policy (the benefit period), or until you return to paid employment.

Making it affordable

Many people who want to take up this type of insurance say that affordability is a barrier. If they then choose not to take it out, they are effectively choosing to 'self-insure', ie they hope they won't need it. However, the numbers are not reassuring. Each year approximately 1 million Australians experience serious injuries or illness that either require hospitalisation or prevent them from working, while approximately 117,000 Australians are 'permanently unable to work' due to illness or injury.[2] Sobering figures indeed.

One solution for working Australians is to take out IP insurance through their superannuation fund. The superannuation fund pays the premiums so day-to-day cash flow for the individual and the family is not compromised.

Matthew's story

A common question people ask when considering this strategy is, 'What's the effect on my long-term retirement savings in my super fund?' Each case will be different and must be assessed on its merits, but the following case study may provide you with some insights.

Matthew is a 35-year-old management consultant, a non-smoker in good health, and earning an annual salary of $100,000. He is considering 'level' IP premiums, ie the premiums do not increase with age but increase via cost of living adjustments or CPI. He has selected a waiting period of 30 days and wants benefits to be payable until he is age 65. He also wants the benefits paid to be the equivalent of 75 per cent of his salary, adjusted annually for inflation. With a mortgage and two young children, Matthew can't squeeze the insurance into an already stretched budget but he decides to pay for the insurance from his super fund.

Matthew reviewed four leading insurers, and calculated that the average level premium was $1,607 per year.

If Matthew does not make a claim over the next 30 years, $70,552 in premiums will be deducted from his superannuation. This dollar amount is not the full cost to Matthew as he forgoes the opportunity to earn a return on those funds each year. If his super fund earned an average of 7 per cent per annum, the foregone compounded return on those funds would have been $13,785 by the time Matthew turns 65. Taking out income protection through super in effect reduces Matthew's available retirement capital by $84,337.[1,3]

Cost versus benefit

The cost of not being able to work is real. If Matthew was unable to work for a period of time, what would be the impact on his retirement? There are two aspects to consider. There is the lost wage itself. But Matthew would still need to fund his living expenses so he would need to either access existing capital or borrow money to live, both of which are a cost to his retirement.

	IP insurance within super and no claim	IP insurance within super and cannot work	Self insure and cannot work
Matthew is unable to work for:	**At age 65, reduction in funds within super ($)**	**At age 65, reduction in funds within super plus 24% of lost salary and interest foregone or interest paid ($)**	**At age 65, total loss from salary and interest foregone or interest paid ($)**
1 year		119,040	148,602
2 years	84,337	153,970	298,176
4 years		224,640	600,796

The table above highlights the effect on Matthew's wealth at age 65 if he was unable to work for one year, two years or four years. It illustrates some of the dramatic financial (and personal) effects that occur in these situations.

Assuming the cost of money is 7 per cent, the total cost to Matthew by age 65 would be $148,602 if he didn't work for one year. There is $107,689 from his loss of income (adjusted for inflation), plus $40,913 from the compounded interest foregone on existing capital, or paid out on borrowings to replace the lost earnings. If Matthew had taken out IP insurance, his available funds at age 65 would be $64,265 higher.

A happy balance

In this case, the significant benefits of taking out IP insurance within superannuation are quite stark and should be considered seriously. Please contact our office if you would like to discuss this option further.

1 Assumes inflation of 2.5%. Assumes base premiums remain stable. Taxation is not taken into account under either scenario.

2 ABS

3 Assumes inflation of 2.5%. Assumes base premiums remain stable. Taxation is not taken into account in either scenario.

Borrowing within an SMSF to purchase property

The financial press has given much recent coverage to a 'new' option for wealth creation – establishing a self-managed superannuation fund (SMSF) and borrowing to invest in direct property.

Before jumping ahead and setting up an SMSF to buy an investment property, you must be aware this area involves complex legislation and rules, and specific financial advice (along with accounting and legal advice), is required to ensure a successfully implemented strategy.

The attraction

Common impediments facing people wishing to build a direct property portfolio include accessing a deposit[1], the ability to generate surplus monthly cash flow (for negatively geared property), and the ability to borrow from a bank.

Using an SMSF can overcome these problems. In fact, subject to the trust deed and investment strategy of the fund, there are no restrictions on which asset class the funds can be invested in. An SMSF can also borrow to leverage the investment, provided the loan is a limited recourse loan for investment purposes, through a trust[2], as explained below.

How does borrowing to purchase property in your SMSF actually work?

The favoured trust for a limited recourse loan is an instalment trust. An instalment trust allows the SMSF to purchase a property, repaying the limited recourse loan by instalment, while the asset is held in the trust which is separate from the SMSF for the life of the loan. If the SMSF defaults on the loan, then the lender's rights are limited to the property in the trust only, while the fund's loss is limited to the equity in the property and all instalment payments made prior to the default.[3]

What types of property can your SMSF purchase?

Residential

SMSFs are able to purchase any residential property at public auction or a private sale, provided it is not purchased from a related party. It cannot be transferred in specie into an SMSF from related-party ownership.

The purchase of direct property must be for investment purposes only and you cannot receive any other benefit from it, so buying a holiday house with your SMSF for you or your family is strictly prohibited.

Business real property

The rules for business real property are different to that of residential property. Business real property includes commercial properties, offices, warehouses and farms. Like residential property it can be bought at auction or private sale. However, unlike residential property, it can be transferred in specie into an SMSF by related parties at market value. Business owners are also able to buy their commercial premises, and pay arm's length rental to their SMSF.

There are taxation benefits from owning business real property within an SMSF, particularly if that property was initially owned outside of superannuation, and/or you are a business owner. Each individual case must be assessed on its merits of course, and key rules still must be adhered to including contribution limits and the work test, as well as taking account of capital gains tax implications.

Appropriate diversification

Depending on the total funds available within your SMSF, your ability to diversify with direct property may be limited. Lack of diversification can increase the risk to your retirement plans if your property investment doesn't perform in line with expectations. It is important to remember even 'blue chip' property prices can lose value. Property values in the USA, UK and Ireland have all decreased by varying degrees over 2008–2010, reminding us that past performance in any market, including property, may not repeat itself in the future. The lesson is... be careful.

Is it right for you now, or in the future?

While members of an SMSF are working to accumulate funds, assets that produce little income for the SMSF may not present any immediate problems. However, in retirement, income (and therefore liquidity), is of paramount importance when specified withdrawal amounts of income are required by law. For example, an 80-year-old member must withdraw 7 per cent of their SMSF capital each year, rising to 9 per cent from age 85.[4]

A significant concern with residential property is that it often produces less than a 5 per cent net rental yield (after expenses)[5] and consequently insufficient retirement income. Because property is not divisible and can't be sold off 'bit by bit', unlike units in a managed fund, accessing liquid funds often results in a forced sale.

Next steps

When buying property through an SMSF you should always consider the quality of the investment with a clear understanding of the associated risks. An objective approach rather than decisions based on emotion will always serve you best in the long run.

Please feel free to contact us to discuss whether this strategy is appropriate for you.

1 Generally, a 20% deposit is required to avoid mortgage insurance.

2 The trust deed of the SMSF must allow the trustee to borrow before any limited recourse borrowing arrangement can be entered into.

3 Source: Adviser Tech: SMSF/Borrowing within SMSF Technical Bulletin.

4 www.ato.gov.au (NB: this amount represents the amount prior to the temporary halving of income stream minimums post GFC to give relief to members wishing to preserve their balances). In the long term, minimum percentage investors should consider with respect to yearly liquidity requirements for their SMSF.

5 www.rpdata.com/press_releases/australia

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