

financially speaking

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Equity markets offer both opportunities and risk

Despite the revival in world equity markets over the past six months, its renewed optimism is still very fragile. It seems it doesn't take much to shake markets, and recent data on lower-than-expected growth in China, or a fall in the price of gold, are enough to send jitters through the markets.

On top of this, there are other major events that can cause serious problems around the world if they go unchecked.

Examination of the world share markets can help investors decide which events are temporary set-backs to the market upturn, and which are more serious threats to global economic health.

Overview of world share markets

Europe

Events in Cyprus and North Korea have caused a bit of a pause in the market resurgence that started in May 2012. Cyprus was significant, not because of its size but because of precedents set in the European Union's handling of the affair.

The head of the European Central Bank, Mario Draghi, commented the European Central Bank (ECB) would "do what it takes" to preserve the euro. It was Draghi's comments that triggered the current market strength, as it was taken to signal a clear commitment by the ECB to preserve the euro. As a result, markets start to recover from their very depressed level.



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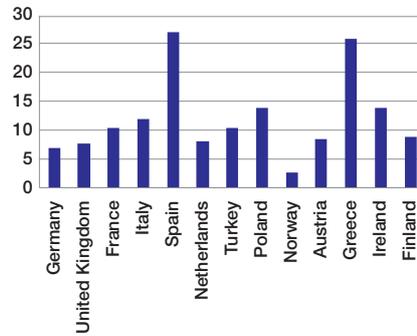
Equity markets offer both opportunities and risk continued

However, events in Cyprus have shaken some of this confidence, after the government initially proposed a measure that would have seen ordinary bank depositors hit with a 'tax' on their savings. It therefore appears to have drawn a very clear line between 'doing what it takes' and 'absolutely anything' to save the euro.

While the decision to give rich Cypriot bank depositors a massive haircut was unpalatable, it wasn't that long ago depositors in Icelandic Banks also got a nasty surprise. A few years later and Iceland is actually looking pretty good. So it's possible to draw the conclusion that tough measures, while unpopular in the short-term with the electorate, could in the medium or long-term be in the best interest of the economy and the people.

There is no doubt European countries, with very few exceptions, are struggling to get their economies back on track. As a region, Europe continues to struggle with high production costs, dodgy bank and state finances and extreme unemployment in southern regions. Unemployment is so high in troubled southern countries there is a real risk of civil unrest, which hampers the implementation of necessary reform. Chart A shows the difference in unemployment rates within Europe.

Chart A: Unemployment figures in Europe



Source: Bloomberg – latest figures available as at May 2013

We've already seen the debacle of the Italian election, and this is just the latest example of a trend where politicians who promise anything to reduce the financial hardship of the population, regardless of how unsustainable or impractical the promise, are given power.

How long this kind of situation can continue is unknown, but any sensible evaluation of the situation suggests that at some point, some hard decisions will need to be made, no matter how unpopular.

North Korea

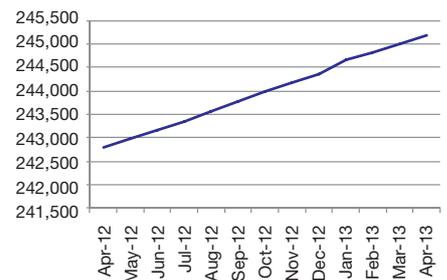
The rhetoric from North Korea obviously isn't helpful for anyone - least of all North Korea. Conflict in Asia has the potential to derail the world growth engine of the past few years. However, even the North Koreans must realise that they have nothing to gain by actually going to war.

We can assume China would take a dim view of activity that impairs its growth prospects. While the brinkmanship has stepped up a level, the most likely outcome is this too will blow over.

USA

The US is looking much stronger, as the economy has been swamped with cheap money for some time. A low exchange rate and low borrowing rates finally appear to be breathing life back into the US industry, providing welcome relief on unemployment. Chart B shows the growth in employment over the past 12 months.

Chart B: USA employment figures



Source: United States Department of Labor as at March 2013

Recent data coming out of the US, such as housing and employment figures, has been positive and, coupled with low interest rates, suggest the US is well on the road to recovery.



Japan

Japan is a real outlier. Recent efforts to reflate the economy have been very well received by equity markets (the Nikkei is up 33.3 per cent in the first four months of 2013), and the collapse of the yen will help recovery. But let's face facts: we've been here before. While policy changes are encouraging there are still plenty of things that can go wrong.

Impact for Australian investors

Despite these setbacks, equity markets have been performing really well. The S&P/ASX 300 Accumulation Index of Australian shares is up 7.6 per cent in 2013 to 31 May, and US based S&P 500 is up by over 14 per cent, and has exceeded its historic high.

The Australian market as a whole will do okay over the long-term, thanks to the Australia's access to natural resources. But there is a supply response coming in iron ore production that will lower commodity prices, and this may be a drag on Australian equity markets in the short-term.

While capital works in the resources sector may be near their peak, these projects will ultimately flow through into improved production that will benefit the economy generally, though there may be some painful adjustments. Expect the prices of resources companies to be volatile.

Outside of resources, Australian companies are struggling with a high Australian dollar, and higher interest rates than international peers. It's hard to see them improving without a radical fall in the Australian dollar.

Factors driving markets

Equity markets are no longer undervalued. In fact, the Australian market is starting to look pricey. Nevertheless, we believe equity markets still have a way to go given the very low returns from cash and bonds.

Low interest rates and bond yields effectively determine the price of all assets. Prospective returns from these assets are currently very low. Over long periods of time the equity risk premium, loosely defined as the extra return investors expect from equities over bonds, has been stable.

Therefore, low interest rates ultimately imply higher prices for growth assets, which ultimately flow through to lower prospective returns. It's fairly easy to justify paying a higher price for equities, property and other investments in this environment.

In the short-term, this is really positive for markets, as prices are more likely to rise as the price of growth assets adjusts to the lower interest rate environment. However, in the longer term it means we will all have to get used to lower returns from all asset classes. In other words, we probably will all need to start saving more than we thought to fund retirement.

Investment opportunities worldwide

Investors really wanting to take advantage of opportunities in equity markets should consider international equities as well as Australian equities. Compared to some international equity markets, the Australian market is relatively restricted in certain sectors.

For example, some of the emerging technologies around 3D printing look really interesting. 3D printing has the potential to automate many production processes, which in due course could restore the competitiveness of a more expensive, labour intensive industry. Companies at the forefront of this technology could be revolutionary.

Other tech companies, such as those in computing and social networking, are now mature. But the social change brought about by the revolution in shopping habits is still in its infancy.

In this new world, companies that have a strong brand will excel. Consumers that are dealing with faceless vendors over the internet are more likely to buy a trusted brand, given they have little reason to trust the vendor.

Managing opportunities and risks

There are always both opportunities and risks in equity markets. Opportunities take time to play out, and adverse events always seem to be reflected in markets immediately. If investors keep a close eye on their objectives, and make sure their portfolios remain appropriate for their circumstances, they may be more prepared to respond to changes in the market. Among other things, that might mean taking profits as equity values rise - if the portfolio risk is creeping up.

As always, diversify, diversify, diversify. Almost all investors will benefit from an allocation to growth assets, particularly equities. Conversely, it's easy to confuse boundless optimism with delusion. Even the happiest optimist should make sure an investment portfolio reflects not just attitude, but personal circumstances.

For more information about how you can invest in Australian and international equity markets, speak with your financial adviser.

Source: Australian Unity, May 2013



SMSFs and Insurance – change is on the way



Self-insurance in general and some specific types of external insurance, such as trauma insurance, are to be outlawed in SMSFs and most other super funds.

Over the last 12 to 18 months, the Government has made a few changes in regards to insurance in superannuation funds. Until recently, the two main changes were:

- a reduction in the amount of tax deductions super funds could claim for some disability insurance premiums; and
- a requirement that trustees of SMSFs consider whether insurance cover should be taken out for members of the SMSF.

What is disability insurance?

Disability insurance provides cover to an individual in the event that they are permanently disabled to the extent that they are unable to work.

Insurance premiums

Regarding the first of those changes, some disability insurance premiums will remain fully tax deductible and others may be partially deductible. The extent of the deductibility depends on the type of disability insurance cover held by the superannuation fund.

The differences in disability cover relate to tests at the time of a disability claim. If the benefits would be payable only if the disabled person is unable to work in any occupation that they have been trained for, then the premiums will be fully tax deductible.

On the other hand, if the benefits could be paid if the disabled person is unable to continue only in the occupation they held at the time of injury or illness, ignoring other jobs they could possibly undertake, then the amount of the tax deduction is reduced.

As that change applied for the year ended 30 June 2012, the firm preparing the accounts for your SMSF should have taken this into account in claiming a deduction for the insurance.

Investment Strategy

Although a SMSF has always been required to have an investment strategy, one of the recent changes requires that it be reviewed regularly - at least annually.

The more significant change is that, when reviewing the investment strategy, the SMSF trustee(s) should consider whether the members of the fund should be insured or, if they are insured, whether the amount of cover is adequate. It is acceptable if the trustee decides not to take out insurance - but the requirement is that it must be considered.

Because of that change, we are seeing a flurry of activity in replacement of investment strategies and it is important for you to discuss your current SMSF investment strategy with your financial adviser.

Limits on types of insurance

More recently, the Government has introduced further changes, including a limit on the types of insurance cover a fund is permitted to hold.

From 1 July 2014, super funds will only be permitted to obtain insurance cover for members if the benefit can immediately be paid to the member (or their dependants).

Some types of insurance cover have been able to be claimed by the

SMSF from the insurer, but limitations on access to superannuation have prevented the benefits being paid to the member. Trauma cover is one such policy which could be paid to the SMSF in the event of a claim but not be accessed by member, possibly until their retirement. Trauma insurance is generally payable in the event of specific events, such as heart attack, certain cancers, loss of limbs and similar occurrences.

Policies for life insurance cover and one of the types of disability cover mentioned previously, where the benefits would be payable only if the disabled person could not work in an occupation they were trained for, would not be affected.

As the changes apply from 1 July 2014 and any cover held in a SMSF before that date can continue to be held by the fund, it is expected that there will be greater focus placed on insurance in a SMSF over the next 12 months, before that particular change applies.

Time for a review?

With a change in the deductibility of some insurance premiums, the need for SMSF trustees to consider insurance for members, and the forthcoming limits on types of insurance able to be held in superannuation funds, now is a good time to review insurance arrangements both in your SMSF and in general. Speak with your financial adviser today.

Source: Topdocs, May 2013

What does a lower interest rate mean for your Super?

Interest rates have hit a record low in Australia. There are many ways you may be able to benefit from these historically low rates.

On May 7, 2013, amid signs of an economy that's continuing its weakening trend, the Reserve Bank of Australia (RBA) cut its official cash rate to 2.75%, the lowest for more than five decades. The rate was passed down in full by all four major banks.

Analysts expect that a further cut in interest rates may well be on the cards later this year, citing the RBA's outlook for lower inflation and slower growth of around 2.5% over 2013.

But less growth in the economy is not always a sign for dismay. Some sectors, like property and superannuation, may actually flourish in a softer economy. And if you're about to retire, this may spell good news for you.

Take property for instance. When interest rates are low, house prices tend to rise since home-buyers get a boost of confidence from lower mortgage rates, and that pushes demand for home ownership. In his statement announcing the rate cut, the governor of the RBA, Glenn Stevens, said a modest recovery in housing investment had already been noted.

You, on the other hand, may be thinking of down-sizing, so your house may fetch a higher price if you decide to sell.

A lower interest rate can also lead to greater investment in the share market as more people search for a better yield in shares. This in turn can have a positive impact on many super funds. Asset values have already begun to rise since many savers have changed their portfolios towards assets with higher expected returns, according to the RBA.

To find out more about how your super can benefit, speak to your financial adviser.

Source: Colonial First State, May 2013

Investment and trading strategies

Investing in and trading bonds can be profitable and improve the quality of your portfolio or chance of a capital gain. In this article, we explore some of the strategies used.

While there are many investment and trading strategies, you'll need to take a view of where the economy (growth and inflation), interest rates and demand are headed. Often there are signals which can help. For example, the Bank Bill Swap Rate (BBSW) and the swap curve are an indication of market expectations of future interest rates. The RBA also publishes its expectations for GDP and growth in its economic outlook statements.

Whatever your views, we'd always recommend that you diversify your investments and in relation to the fixed income asset class investors should seek diversification by:

- investing in different types of bonds (fixed rate, floating rate and inflation linked)

- investing across various sectors (government, semi-government, corporate, financial institutions, insurance and infrastructure)
- investing across domestic and international issuers
- considering foreign currency bonds if you hold other currencies in your portfolio or have a future need for a specific currency

Diversification reduces risk and helps protect your portfolio, so that declines or losses in any one asset class, sector or issuer are minimised across your portfolio.

Different types of bonds have different roles to play under various economic cycles. When a cycle ends and another begins, it is worth assessing whether

your bond portfolio has performed the role it was intended to perform. Near or at the high and low points of the economic cycle are the times to consider changing the emphasis of your portfolio but diversification remains key.

Economy starts to contract

Under a contracting economy, investors would have a preference for fixed rate, longer dated bonds. The aim would be to sell these bonds once you thought the economy had reached the low point to maximise your gain (remember the inverse relationship between price and yield). To make use of these strategies you need to take a view of the market.

Investment and trading strategies continued

1. Risk off – Flight to quality

Under this strategy you anticipate a contracting economy and sell higher risk assets and buy low risk, high credit quality assets. Using the capital structure as a guide, you would sell off equities and hybrids, preferring senior secured and senior unsecured debt. Investors would prefer to invest in the lowest risk issuers such as the Australian Commonwealth government or semi-government or assets that sit higher in the capital structure such as covered bonds issued by the major Australian banks. During the GFC, investors seeking low risk high credit quality assets sought government bonds as a safe haven (see the case study below).

During an economic contraction, demand for low risk assets increases and this higher demand pushes the price of the bonds higher and the credit spreads lower. Investors are nervous about an increase in company defaults. As we know, investors that sit low in the capital structure take the brunt of a default, while the more senior debt holders are often protected.

2. Capital preservation

Capital preservation is similar to a flight to quality although this strategy aims to make sure that no capital is lost. Investors sell assets that sit low in the capital structure such as equities,

hybrids and subordinated debt of high risk issuers and buy senior or senior secured bonds. An investor switching out of higher risk assets might target government or semi-government bonds or government guaranteed bonds, although high quality corporate bonds that are short dated (thus increasing certainty about repayment) would also make good additions to this portfolio strategy.

3. Buy fixed rate bonds and have a preference for them in your portfolio, sell floating rate notes

When an economy starts to contract the RBA will start to cut the cash rate to stimulate growth, which means investors, over time, will expect to earn less for their investments. Buying fixed rate bonds mean that as interest rates come down, the price of the bonds will rise, offsetting losses in other parts of your portfolio such as property and equities. Fixed rate bonds will also protect your income stream. The coupon you earn on your floating rate notes will decline (as it is linked to a benchmark rate such as BBSW, which reflects the markets' perception of interest rates) and as investors sell out of FRNs in preference for fixed rate securities, it's likely that the price of the FRNs will also decline.

4. Switch out of short dated fixed rate securities and into long dated fixed rate securities to increase duration and lock in known returns for longer

Locking in returns for longer makes sense when you're unsure of how long a downturn will last. Think about the Japanese market which until recently had been in a low growth scenario for many years. The longer you can lock in that fixed rate return the better, not only in the sense of protecting the level of your income but longer duration investments will also have greater fixed rate bond price increases if you sell the bond after interest rates fall.

5. Lock in longer dated term deposits

Just like fixed rate bonds, you would lock in longer term deposit rates. Westpac offered a high 8% fixed for five years at the start of the last contraction and those clients who accepted the long term commitment and could afford to lock away those funds made a good decision, when comparative rates for the same term at the end of 2012 were around 5.0%.

Source: FIGG, May 2013

CASE STUDY

In the 2011/12 financial year, the best performing asset class was Australian Commonwealth government bonds. Investors seeking a flight to quality and to preserve capital started buying these bonds. In particular, as the European financial crisis deepened, foreign investors sought refuge in AAA rated Commonwealth government bonds and highly rated semi-government bonds. The AGL 15 July 2022 bond rose in price from \$103.59 as at 1 July 2011 to \$123.30 at 29 June 2012. The bond price reflected higher demand and the bond's yield contracted. Investors were more concerned about capital preservation than the low yield the bond provided, although the yield was comparatively high for a AAA rated sovereign at the time.

The psychology of retirement

Living the good life, retiring happy, wealthy and wise.

Retirement is a little like Clark Kent taking off the Superman suit. It's peeling off an identity – from an industry, a company, or a personal work history – and entering an entirely new life stage.

There's freedom and excitement, the time to do all the things we've been waiting for, but there's also some key life changes and adjustments to make, some of which may be totally unexpected.

Although retirement is one of life's most mentally challenging milestones, retirement advice usually focuses on finance rather than feelings. Planning for both can make a tremendous difference.



The bright side & the down side

So, what are the changes we face when we step into the retirement phase?

Time stretches luxuriously in front of us, something many of us have craved our entire working lives. Time to travel, read the books we've always wanted to read, take up a new interest or spend hours doing what we love. Some of these activities require money; many just need a good attitude and a mind that loves a challenge. However they all hinge on what retirement offers: time, and a lot of it.

But retirement can carry a downside. As Dr. Robert Delamontagne writes in *The Retiring Mind: How to Make the Psychological Transition to Retirement*, "For the first time in my life, I had no answers. I had fallen into a black hole where there were no guideposts for me to follow. What had happened to me? I built a successful company and lived a very active and dynamic life...yet I had no clue what to do next. For the first time in twenty-five years, I did not have a company to manage, nothing that urgently needed to be done, and, most troubling, no one who needed me to make a decision or contribute to a discussion. I did not play golf, nor belong to any clubs, and had little interest in doing either.

I wish that I had though, because brother, was I stuffed."¹ The challenges of retirement can be numerous – from dealing with a change in identity and filling the hours previously spent working, to being labelled 'retired' or feeling unneeded. With no job, industry, company or colleagues to confirm who we are and where we fit, it's easy to forget our own sense of purpose.

Charting a new course

Whether retirement is a goal or an unexpected curve ball, planning for retirement mentally as well as financially is key. Some people take a hybrid approach and continue working – either part time, in a consultancy role, or in a new industry with reduced pressure (and salary).

Many choose to get involved as a volunteer, evidenced by the 34% of the adult population of Australia who volunteer at least one hour every week with community organisations.² Others take on a new project, sign up for courses, or help family raise young children.

Charting a new course for retirement means we need to think about our values – and act on them. What we do with retirement will give us satisfaction if it lines up with what we truly value. It's wonderful to take care of the grandkids, for example, but extremely important to decide upfront how much time you're happy to give. And buying that beach house is only a good idea if you love relaxing, which some people actually don't.

Feeling good about retirement is an important goal, but it may not come as naturally as we think. It's important not to underestimate the psychological impact and that's where planning can help. Sorting out real values from perceived values will help us transition into retirement – and live the good life we've been waiting for.

¹ Delamontagne, Dr Robert P. *The Retiring Mind: How to Make the Psychological Transition to Retirement*, Synergy Books, 2010, pp.1 – 2.

² Volunteering Australia FAQs. www.volunteeringaustralia.org

Source: Russell, May 2013

Happy new financial year!

Everyone thinks about change and making resolutions when the calendar year ends, but what about the financial year end?

The new financial year is a perfect time to make some resolutions to improve your financial health. If you create simple and easy-to-follow resolutions you will be more likely to succeed. To start, you can ask yourself the following questions:

- What do I really want to change?
- What are the benefits of making changes?
- What steps do I need to take to make changes?
- What will stop me from making positive changes?
- Are my changes realistic and long term?

This article lists some simple, easy-to-implement resolutions you could take on for the new financial year.

Keep your receipts

The most common reason people don't take advantage of tax deductions when they file their tax return is simply because they don't keep receipts. While keeping receipts for big ticket items is necessary, you don't always need a receipt for the smaller items such as stationery and books.



Create a budget

Achieving your financial goals doesn't have to be daunting; a good way to start is with a budget. Try to keep a diary of your expenses and your spending. This will enable you to track where your money is going and how much spare cash you can use to either attack your debt or build investments.

Cut your spending

Look at cutting unnecessary expenses. This could be as easy as making your lunch or coffee at home, cutting out optional extras such as lottery tickets or taking public transport instead of driving.

Pay extra

Try paying more than the minimum off your debts. Whether it's personal loans or credit cards, paying the minimum will hardly make a dent as you will only be paying off the interest.

Increase your savings

Set aside a little bit of extra money each day, week or month. If you can save just \$10 a day, you will have an extra \$3,650 at the end of the year. You can talk to your employer about getting it automatically deducted from your pay – if you don't see it you are less likely to miss it.

Contribute to your super

Think of the long term and your lifestyle when you retire. One way to increase your retirement savings is through salary sacrificing some of your pre-tax salary.

This will not only help to increase your super savings but could also reduce the amount of tax you pay.

Seek professional advice

Your financial adviser will help you keep to your resolutions and make sure your financial strategy is appropriate for the year ahead.

Source: IOOF, May 2013



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