QUARTERLY INSIGHT

InterPrac Financial Planning Newsletter Winter 2016

2015/16 FINANCIAL YEAR @ A GLANCE

0.56%

The S&P/ASX 200 returned +0.56%, being a -4.13% price decline offset by +4.69% dividend income.

AUSTRALIAN SHAREMARKET

Australian shares outperformed most of our international peers in both price return (an average of -8.5%) and dividend (2.5%), even though our two major sectors, banks and resources, faced a more difficult trading environment. The two headwinds that have restrained returns over the year are elevated valuations and a more difficult earnings environment, which capped gains despite increased policy support from the government and the RBA. During the financial year, there were two distinct periods of volatility in August/September 2015 and January/February 2016, which sparked larger than-normal losses.

On the macro front, Australian economic growth accelerated as the country continued to transition from the mining investment boom, with unemployment declining to a 3 year low of 5.7% and housing construction remaining upbeat given favourable interest rate settings.

1.75%

The Reserve Bank of Australia cash rate (as at 30 June 2016)

INTEREST RATES

Despite numerous international headwinds, the Australian economy has performed strongly over the past year, with growth of 3.1%, around double that of most of our G20 advanced economy peers. Despite this, the Reserve Bank of Australia cut the target cash rate to a fresh record low of 1.75% given concerns that both headline and core inflation is too far below their 2–3% target band.

More importantly, the RBA seemingly believes that inflation is likely to remain at historically low levels for an extended period. This is good news for household budgets, but not for nominal earnings growth or the Federal Budget. Lower inflation also culminated in our 10 year bond yield trading below 2% for the first time ever. The downward pressure was amplified by falling global yields in response to a weaker international climate, central banks' asset purchase programs in Europe and Japan, and specific risk events, including Britain's referendum on EU membership.

76.17c average

High of 78.12 cents and low of 68.67 cents, against the US dollar

AUSTRALIAN DOLLAR

The Australian dollar declined for a second consecutive year against the US dollar. Despite several key headwinds, the currency proved quite resilient as investors remained attracted to our relatively high yields, which helped offset the impact of a sustained reduction in commodity prices.

Elsewhere, there appears to be more pressure on Australia's AAA credit rating (which has been a keystone to the currency's strength over the past six years). This pressure is influenced by Australia's growing debt burden, even though this stock of government debt remains modest relative to other major global economies. The positive and negative factors impacting the currency culminated in the Australian dollar depreciating modestly against most major international currencies, including the Yen, Euro and US dollar. It appreciated slightly against the major Asian currencies, as a moderation in China's growth profile weighed heavily on commodity exposures.

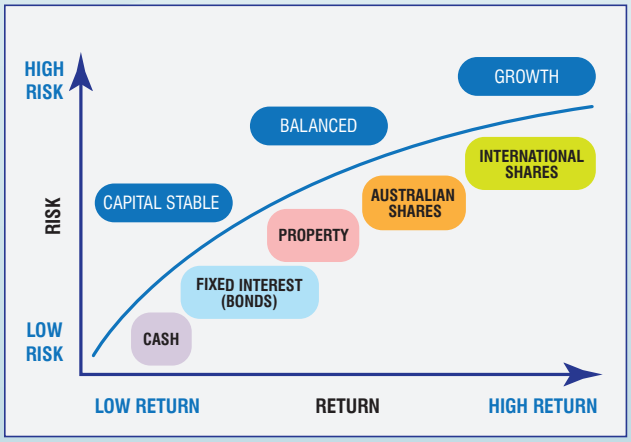
Article courtesy of Perpetual

UNDERSTANDING

When deciding on an investment, it is important to understand the expected risk and likely returns from the investment and determine how this fits with your personal situation and financial needs.

Investments are expected to provide a return, but this return will come with a certain level of risk. Risk means different things to different people and typically it is referred to as either the uncertainty of the return or the risk of losing your capital.

The relationship between risk and return is demonstrated in the graph below.



As a general rule, the higher the potential return from an investment, the greater is the investment risk and the probability of experiencing capital losses.

The first step in determining whether an investment is appropriate is to understand the relationship between risk and return, and then to determine the level of risk and return that you are comfortable with. This also requires an understanding of the level of risk you may need to accept to generate the likely returns required to meet your financial goals.

What is Risk?

Risk means different things to different people. Most people think of risk as the chance of losing their capital. Others describe risk in terms of the 'ability-to-sleep-at-night' test. You don't want to lie awake at night worried about your investments, so understanding and accepting the risk of an investment will help you get a good night's sleep.

In investment terms, risk is often described as the level of unpredictability of returns or the chance that returns will be different (higher or lower) than expected.

There are many kinds of risk. Some of these include:

- CAPITAL RISK: losing your invested capital
- MARKET RISK: needing to sell an investment at a time when the price is low
- INFLATION RISK: the investment's rate of return does not keep pace with inflation
- INTEREST RATE RISK: a drop in the investment's interest rate
- LIQUIDITY RISK: limitations on access to funds for a period of time
- LEGISLATIVE RISK: changes in laws including tax and superannuation which may make investments less attractive
- DEFAULT RISK: the failure of an institution in which an investment has been made

Risk can also be described as the chance that you will not achieve the investment returns needed to meet your financial objectives. While some people may be more comfortable with accepting low levels of risk, the potential consequence may be that the returns achieved are insufficient to meet their financial objectives. For example, this may mean that the required level of savings is not available when needed to pay for items, such as retirement or children's education expenses.

Example: June has $400,000 to invest. She plans to use the funds in 10 years' time and needs her investment to grow to at least $800,000.

If June decides to invest in defensive (low risk) assets that are expected to return 5% per annum after fees, her portfolio is expected to grow to $651,558. This is not enough to meet her goals.

Alternatively, June could invest in higher risk assets that are expected to return 8% per annum after fees. In this scenario, June's portfolio is expected to grow to $863,570 and be sufficient to meet her goals.

This represents a difference of $212,012 and the potential to meet her goals.

The higher risk investments are more likely to help June achieve her financial goals. However, June needs to accept the trade-off of greater unpredictability of returns over the 10 year period and the potential for capital losses or poor performance.

Investment Time Horizons

One way of looking at risk is to look at the possibility of negative returns from the investment. The probability of negative returns from an investment will also depend on how long the investment is held. The probability of losses reduces the longer the 'risky' investment is held.

The following Financial Year Returns table demonstrates that investments with a higher level of risk, such as shares and property (as measured by standard deviation), can have vastly different returns over short one year periods when compared with relatively low risk investments like cash and fixed interest. Over this 20 year period however, returns from more 'risky' investments tend to be higher than returns from more conservative investments.

RISK & RETURN

For this reason, it is recommended that more risky investments be held with the intention of staying invested for a long term, such as five years plus. Generally the higher the level of risk of an investment, the greater is the recommended investment time horizon.

Example: Georgie is investing for her retirement within a superannuation fund. She is at least 20 years away from retirement. Georgie is also saving to buy a new car in 12 months' time. Georgie has different investment time horizons for the two financial goals.

She may wish to choose investments that have a higher level of risk in her superannuation fund because she has a long term investment time horizon and is in a position to ride out the ups and downs of financial markets. However, the savings needed to buy the car have a shorter investment time horizon and Georgie may prefer more conservative investments for this part of her savings.

FINANCIAL YEAR TOTAL RETURNS % FOR THE MAJOR ASSET CLASSES

YEAR TO 30 JUNE	CASH	BONDS		PROPERTY		SHARES			
		AUSTRALIAN	INTERNAT'L (HEDGED)	AUSTRALIAN	INTERNAT'L LISTED	AUSTRALIAN	INTERNAT'L	INTERNAT'L (HEDGED)	US
1986	18.3	20.5	29.2	23.8		42.5	55.2	34.5	33.5
1987	17.3	12.1	17.6	41.3		54.0	32.6	33.2	17.7
1988	12.5	19.4	12.5	-2.8		-8.6	-10.0	-5.3	-15.5
1989	15.7	3.0	16.3	-1.1		3.5	18.1	18.3	26.7
1990	18.5	17.8	13.1	15.2		4.1	1.9	5.3	11.5
1991	13.5	22.4	15.3	7.7	-15.9	5.9	-2.0	-5.8	10.3
1992	9.0	22.0	15.8	14.7	6.9	13.3	7.1	-3.0	16.3
1993	5.9	13.9	14.7	17.1	28.3	9.9	31.8	17.3	26.6
1994	4.9	-1.1	2.1	9.8	8.4	18.5	0.0	6.7	-6.5
1995	7.1	11.9	13.1	7.9	7.5	5.7	14.2	3.7	30.0
1996	7.8	9.5	11.2	3.6	2.4	15.8	6.7	27.7	12.9
1997	6.8	16.8	12.1	28.5	35.7	26.6	28.6	26.0	42.6
1998	5.1	10.9	11.0	10.0	25.0	1.6	42.2	22.1	58.2
1999	5.0	3.3	5.5	4.3	-6.8	15.3	8.2	15.9	14.2
2000	5.6	6.2	5.0	12.1	14.1	13.7	23.8	12.6	18.2
2001	6.1	7.4	9.0	14.1	38.2	8.8	-6.0	-16.0	0.5
2002	4.7	6.2	8.0	15.5	7.5	-4.5	-23.5	-19.3	-26.3
2003	5.0	9.8	12.2	12.1	-5.2	-1.1	-18.5	-6.2	-15.2
2004	5.3	2.3	3.5	17.2	28.7	22.4	19.4	20.2	15.4
2005	5.6	7.8	12.3	18.1	21.2	24.7	0.1	9.8	-4.1
2006	5.8	3.4	1.2	18.0	24.2	24.2	19.9	15.0	11.6
2007	6.4	4.0	5.2	25.9	3.0	30.3	7.8	21.4	5.6
2008	7.4	4.4	8.6	-36.3	-28.6	-12.1	-21.3	-15.7	-23.4
2009	5.5	10.8	11.5	-42.3	-31.2	-22.1	-16.3	-26.6	-12.5
2010	3.9	7.9	9.3	20.4	31.3	13.8	5.2	11.5	8.9
2011	5.0	5.5	5.7	5.8	9.2	12.2	2.7	22.3	3.7
2012	4.7	12.4	11.9	11.0	7.5	-7.0	-0.5	-2.1	11.1
2013	3.3	2.8	4.4	24.2	24.3	20.7	33.1	21.3	32.5
2014	2.7	6.1	7.2	11.1	11.8	17.6	20.4	21.9	22.7
2015	2.6	5.6	6.3	20.3	23.1	5.7	25.2	8.5	31.8
Average	7.6	9.5	10.4	10.9	10.8	11.8	10.2	9.2	12.0

Notes: 1. *Index prior to 30 June 2008 is the Citigroup World Government Bond Index AUD hedged, from 30 June 2008 the index is the Barclays Global Treasury Index AUD hedged (previously Lehman Global Treasury Index AUD hedged).*

2. *Index prior to 1 May 2013 is the UBS Global Real Estate Investors Index ex Australia with net dividends reinvested, from May 2013 the index is the FTSE EPRA/NAREIT Developed ex AUS Rental Index with net dividends reinvested.*

3. *MSCI World ex-Australia Net Total Return Index (Local Currency) represents a continuously hedged portfolio without any impact from foreign exchange fluctuations.*

Past performance is not an indicator of future performance.

Wealth Check-Up

One of the most important keys to successful wealth planning is knowing where you stand from a financial, wealth and estate planning perspective and anticipating how future events might impact your current planning. The new Financial Year brings with it an opportune time to undertake a wealth check-up.

Back to basics

Life circumstances are ever changing. Whether it is marriage, divorce, buying a house, welcoming a child, saving for education, redundancy, retirement or receiving an inheritance, these events will all have an effect. They can also require changes to your investment strategies and goals.

The first step is to look at what has changed during the year. This will impact your income and outgoings. You may think you know, but you may be surprised when we crunch the numbers.

From here we can make any necessary adjustments to your financial plan, to assist in continuing to meet your goals and objectives.

Not so Super?

Superannuation is a cost effective method of saving for your retirement.

Many people may not think twice about signing up with their employer's default fund when taking on a new job, but it's always worth a closer look. It is always important to remember, if you have multiple accounts, you will be paying multiple sets of fees, as every fund has a variety of associated costs, performance fees and management fees. Rolling super into one account can help simplify investments and may reduce costs.

Whilst it may be simple to set up regular salary sacrifice payments with your employer, just be mindful of the superannuation contribution caps, especially with the proposed changes announced by the Coalition Government prior to re-election.

Estate planning

Changes like births or deaths, a marriage or divorce, shifting of assets, or a family move, may necessitate changes in your key estate planning documents. This also is a good time to take a fresh look at whether your executors, trustees and guardians are still capable of serving in these roles.

In addition, if your financial situation has changed drastically over the past year, your Will may need to be updated to reflect these changes.

Giving back

Many of our clients, like you, already donate to charities and philanthropic organisations which reflect their own values. Whilst the most common approach is to make one-off donations, a more structured and considered approach to philanthropy will have greater impact for the charity or organisation.

One of the challenges facing charities is how to manage the uneven levels of donations they receive. This is why many charities and organisations encourage monthly payment donations, as it is much easier for them to achieve their goals when they are able to accurately forecast a regular income stream. Structured payments can be built into your financial plan so your nominated charity can commit to set projects. These valuable contributions can make a big difference.

Undertaking your wealth check-up early in the financial year can help you plan for your best financial future in 2016-17.

Risk and Return in a Low Interest Environment

Investors today are grappling with historically low interest rates, and consequently have to take bigger risks if they want to achieve the same returns as achieved 20 years ago.

Twenty years ago retirees could get 7.5% return from bonds alone. To achieve that return today requires a jump up the risk curve (see the "Understanding Risk and Returns" graph on page 2). Simply achieving a modest return is getting harder and the wider economic environment more challenging.

The big question for retirees today is not how to exponentially grow what you have, rather how to maintain your lifestyle, when term deposits and bonds are paying next to nothing.

One of the keys to this is moderating your expectations. The 10-15% per annum returns achieved over the past few decades is no longer the norm, we need to revise our expectations down.

Another is focusing on value in the stocks you buy, rather than worrying about what's happening elsewhere in the world. If you buy stocks cheaply enough (at a discount to fair value), the macro risks are usually accounted for in the price. In fact, the presence of these macro risks creates the opportunities. If you keep things simple and focus on valuation, the rest is noise.

Lastly, assuming you can afford to, don't get too hung up on yield. One of the interesting features of the last few years is that whilst two years ago we were seeing stocks with high yield pushed above historical valuations, today we are experiencing a cycle of the opposite. Yield has become relatively expensive, whilst growth, particularly in small caps, relatively cheap.

When a clear preference emerges, as is the case with dividends now, mispricings follow. The price of high-yield stocks have been pushed up by income hungry investors, at the expense of those companies reinvesting profits. If you don't care too much about where your returns come from, opportunities are plenty. Owning a small slice of even a modestly growing business is a better option than almost everything else right now.

Eight ways the 2016 Federal Budget could change how you invest for retirement

From NAB Group Chief Economist **Alan Oster**

The 2016 Federal Budget included a number of significant changes to superannuation, which may have important implications for your investments in super. These changes are proposed to take effect on 1 July 2017, except "Changes to non-concessional contributions", which was effective as at 7:30pm (AEST) 3 May 2016.

Whilst the Coalition Government has survived the recent Federal election, the close results may yet see some negotiations regarding these proposed changes.

1. LOWER CAP ON CONCESSIONAL CONTRIBUTIONS

The annual cap on concessional contributions you can make without a tax penalty will reduce to $25,000, regardless of your age. However, you may be able to contribute more if you haven't fully used the cap in previous financial years.

Concessional contributions include salary sacrifice, superannuation guarantee, personal contributions you claim as a tax deduction, and some other amounts.

The cap on your concessional contributions currently depends on your age.

Concessional contribution caps		
AGE	ANNUAL CAP AMOUNT	
	2015/16 and 2016/17	From 2017/18
48 or under	$30,000	$25,000
49 or over	$35,000	$25,000

2. ADDITIONAL TAX ON CONCESSIONAL CONTRIBUTIONS

Broadly, you'll pay an extra 15% tax on concessional contributions if you earn more than $250,000. This additional tax (which is, generally, payable on top of the standard maximum tax rate of 15% on concessional contributions) currently applies if you earn more than $300,000.

Tax on concessional contributions		
INCOME[1]	ANNUAL CAP AMOUNT	
<$250,000	15%	15%
$250,000 to $300,000	15%	30%
$300,000	30%	30%

[1] Including concessional contributions.

3. 'CATCH-UP' CONCESSIONAL CONTRIBUTIONS

You can make concessional super contributions above the annual cap if:

- you haven't fully used the annual cap in previous financial years, and
- your super balance is less than $500,000.

Only cap amounts you haven't used from 1 July 2007 can be carried forward, for up to five years.

This change could help you make 'catch up' contributions if you haven't been able to use the caps due to broken work patterns or other financial commitments.

4. CONTRIBUTIONS BETWEEN AGES 65 AND 74

If you're between 65 and 74, you'll be able to make contributions whether you work or not. Currently, you need to work 40 hours in 30 days in a financial year to make super contributions at this age.

5. TAX DEDUCTION FOR SUPER CONTRIBUTIONS

You'll be able to claim tax deductions for personal contributions, regardless of your employment status. Currently, you can claim a tax deduction only if you're self-employed or earn less than 10% of your total income from employment sources.

6. NEW SUPER PENSION LIMITS

A lifetime limit of $1.6 million – 'the transfer cap' – will apply to the amount of super you can transfer to start a pension.

If you have an existing pension over $1.6 million, you'll need to reduce the balance below this limit by 1 July 2017 to avoid penalties.

Earning on investments you hold in a pension (other than a transition to

retirement pension) will continue to be taxed at 0% and earnings on any balance that remains in super will continue to be taxed at 15%.

7. TRANSITION TO RETIREMENT PENALTIES

Earnings on investments you hold in a transition to retirement pension will be taxed at 15% (currently 0%). A transition to retirement pension is a pension you start with super money when you reach your preservation age, which is between 55 and 60 depending on your date of birth. Once you permanently retire, or meet another condition of release, it's expected the underlying earnings will be taxed at 0%.

8. CHANGES TO NON-CONCESSIONAL CONTRIBUTIONS

A lifetime non-concessional contribution (NCC) cap of $500,000 applies, effective 7:30pm (AEST) 3 May 2016, and all NCCs you make on or after 1 July 2007 will count towards this lifetime cap.

NCCs are after-tax super contributions. They include personal contributions where you don't claim a tax deduction, contributions you make on behalf of a spouse and certain other amounts.

Any contributions you make above this lifetime limit (and assumed earnings on these amounts) will incur penalty tax if you don't withdraw them.

These measures replace the current NCC cap of $180,000 pa, or $540,000 over three years if you meet certain conditions.

Is Your Future Super?

Nearly three quarters of Australian workers (72%) don't know that the current superannuation guarantee rate is 9.5%, according to the recently released 2016 Australian Employee Insights Report, commissioned by Sunsuper and conducted by Galaxy Research. The survey interviewed more than 1000 Australian employees aged between 18 and 69, and who worked in businesses with at least 20 staff.

Whilst the report found that getting paid higher super contributions was one of the highest rated benefits that companies could offer their employees (43%), less than one in five employees (18%) say they currently receive this as a corporate benefit. The results are worrying, especially when you consider employer contributions are the main way most Australians save for their retirement.

The report also highlighted that a third of Australians are unsure about what age they can access their superannuation and the same percentage are unsure whether they will have enough super when retiring. Despite this uncertainty, having enough money to fund retirement was considered the top financial dream for Generation X and Baby Boomer participants in the survey. For Gen Y, the top financial dream was having money to buy their first home.

Unsurprisingly Australians' most common dream for retirement is to travel overseas (58%). If money was not an object one in six Australians would retire at 40 and the report also highlighted 19% of Australians want to "grow old disgracefully". Paradoxically more than one in five (21%) say retirement makes them feel scared or sad.

Interestingly, whilst almost half (49%) of Australians would go to their employer when looking for information about their super, the report also found that while less than half of Australians (46%) always trust their immediate manager, less than a quarter (24%) always trust senior management.

If you know someone who would benefit from engaging a trusted adviser to help them understand their current position and what is needed to achieve their financial goals, give us a call, we're here to help.

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