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Counting the cost of a curve ball

Here's a confronting question: what would you do if the main breadwinner in your household could no longer bring in an income? Do you have a Plan B? Most people don't. That's where insurance comes in.

Curve balls. They're unexpected, often deceptive and it's impossible to predict their trajectory. That's why they're so devastating – in sport and in life. There's some interesting data now available about the kind of curve balls that can impact your life, your finances and your retirement.

The headline figure is this: one in three Australians could be disabled for more than three months before turning 65[1]. If you combine this with another startling fact – that 60 per cent of Australian families with dependants will run out of money if the main breadwinner can no longer bring in an income – you can see the problem. Curve balls are pretty common, but so few people are prepared for them.

With the mortgage to pay, school fees to fund and day-to-day living expenses to meet, you could run down your savings very quickly and face financial difficulty.

Inside this edition

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The table below shows what's at stake in terms of potential earnings to age 65. For example, if you are currently 45 and earn $80,000 per annum, you could earn around $2.15 million over the next 20 years. Isn't that worth protecting?

Current income (per annum)	Current age			
	25	35	45	55
$40,000	$3,020,000	$1,900,000	$1,070,000	$460,000
$60,000	$4,520,000	$2,850,000	$1,610,000	$690,000
$80,000	$6,030,000	$3,810,000	$2,150,000	$920,000
$100,000	$7,540,000	$4,760,000	$2,690,000	$1,150,000

Assumptions: Income increases by three per cent per annum. No employment breaks. Figures rounded to nearest $10,000.

What kind of Plan B do you need?

The last thing you need to worry about when you're dealing with a curve ball is your finances. That's where insurance comes into its own. It's a well-known saying that you only realise the value of insurance when you need it – and you don't have it.

Taking out income protection insurance could provide you with a monthly benefit of up to 75 per cent of your income to replace lost earnings while you recover.

Most income protection policies offer a range of waiting periods before you start receiving the insurance benefit (with options normally between 14 days and 2 years). You can also choose from a range of benefit payment periods, with a maximum cover period generally available up to age 65.

Other things to consider

- Income protection insurance premiums will generally be lower if you choose a longer waiting period and shorter benefit payment period.
- If you don't have sufficient cash flow to fund the income protection premiums, you may want to arrange the cover in superannuation, where the cost will be deducted from your account balance.
- Other curve balls you may want to insure for include critical illness (such as cancer and stroke), total and permanent disability and death. These curve balls can be covered by different types of life insurance, which you may want to consider.

1 Calculations based on data from the Institute of Actuaries of Australia 2000. Interim Report of the Disability Committee. IA Aust: Sydney.

Source: MLC

Property and diversified portfolio

Diversification is the standard tactic employed to reduce the total risk of your investment portfolio. By spreading your investment risk across different asset classes, geographic markets, time periods, fund managers and shares, losses should be isolated to independent asset classes and ideally, can be offset by gains on other assets.

Why include property?

As one of the major asset classes, property is indispensable to a well-diversified portfolio. From the investor viewpoint, property can be split broadly into residential, commercial, industrial and retail sectors. It can also be directly owned, like most residential property, or indirectly owned through a managed fund, a syndicate structure or through a real estate investment trust (A-REIT).

All classes of property provide valuable diversification as property returns tend to move independently of other major asset classes such as shares and cash. Additionally, both residential and direct property have a low or negative correlation with other asset classes providing excellent portfolio diversification benefits.

What type of returns does property offer?

Another consideration for your portfolio is the balance between 'growth' assets and 'defensive', or 'income' assets. Growth assets tend to carry greater risk, yet have the potential to deliver higher returns over longer investment time frames.

In contrast, defensive assets tend to carry lower levels of risk and therefore, are more likely to generate lower levels of return over the long term.

Whilst generally classified as a growth asset, property can also provide reliable income through rental returns, along with capital growth through asset price appreciation over time. Property values fluctuate more than fixed interest and cash but not as much as shares. It is for this reason that property is regarded as a growth asset, but one at the lower end of the risk spectrum with some defensive or income characteristics.

Property in different stages of life

Investors seeking to build wealth tend to have an appetite for growth assets at the higher end of the risk spectrum. Younger investors particularly have a higher tolerance for short term fluctuations in value as they are more likely to be able to sit out the troughs inevitable in long term investment cycles.

While investors approaching retirement tend to have an increasing allocation to lower risk assets, most retirees require income from their portfolio. This makes property an increasingly attractive option in a retirement portfolio because it generally has lower risk than shares but pays a much higher income than cash.

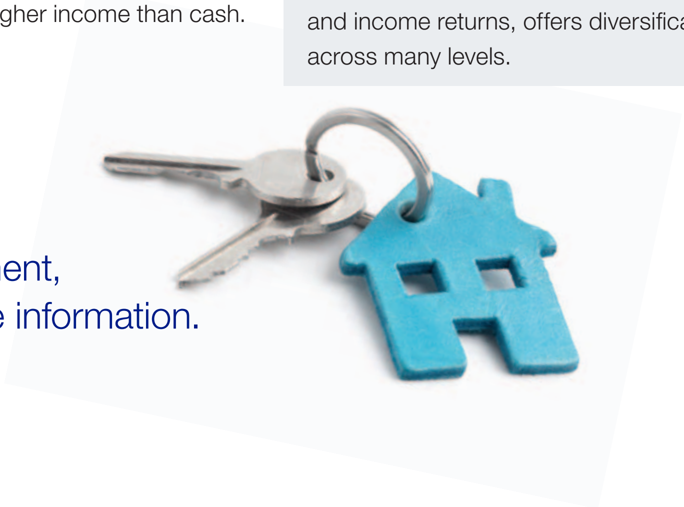
Direct or managed property investment?

The most common direct investment made in property in Australia is in residential. Residential property is tangible, can offer tax advantages and is an asset that many investors have experience with and, therefore, understand. However, investment portfolios that hold direct residential property can be poorly diversified due to a large percentage of capital concentrated in the one illiquid asset.

As an alternative to direct property, direct property trusts, funds and A-REITs can provide many levels of diversification and flexibility to a portfolio. Whilst providing exposure to capital growth from property price appreciation, as a unitised investment they are easier to trade.

Greater diversification within the one asset class is also possible, as a reduced initial investment can provide exposure to multiple properties or sub-sectors such as retail, commercial, and industrial.

Property is an essential part of any well diversified portfolio and, in addition a balance of potential capital growth and income returns, offers diversification across many levels.



If you are interested in property investment, speak to your financial planner for more information.

Source: Cromwell Property Group

SMSF borrowing gets the amber light

If you are an avid follower of all things political, in November 2015 you would have heard that the Government provided its response to recommendations raised in the Financial System Inquiry. Of particular note for SMSF trustees was the Government's decision not to proceed with the recommendation to remove the ability of super funds to borrow.

This should not be taken as the green light for SMSF trustees to start looking at any gearing opportunity. Indeed, the Government has said that they will review the position again in 2018 on the back of improved reporting from the ATO.

Any decision about borrowing within your SMSF should be based on a few key principles:

Firstly, what is the long term goal you are trying to achieve?

The primary purpose of super as an investment vehicle (or sole purpose under the law) is to help you grow wealth for your retirement. This is why super funds receive the tax breaks they do.

If you are thinking about gearing in your SMSF, does your strategy line up to this goal? An easy answer is to say "yes" on the basis that gearing should increase your wealth over time. But of course, gearing also introduces additional risk on the downside and has the potential to exacerbate losses if investment markets don't perform as expected.

Secondly, does your gearing choice align to your timeframes?

While this might sound like a silly question, often it is not carefully considered. It's possibly illustrated by an example.

Let's use an example where you are borrowing within your fund to acquire a residential property. When you think about most residential investment loans, the loan itself often has a term or timeframe exceeding 20 years. How does this 20 year repayment timeframe align to your personal goals?

If you were aged 40 and planned to retire at around 60 years of age, then this strategy could make sense for you. However, what if you were aged 50 and planned to retire in 10 years? At age 60, you would have still have 10 years left on the loan, but may have difficulty in making additional contributions into your fund if you are no longer working. If that meant you were then forced to sell the property because either you can't afford the repayments going forward, or you needed the cash (or liquidity) to fund your retirement needs, then you may be forced to sell at a time you didn't want. Or the market may have moved backwards so you actually don't have the overall growth originally anticipated.

Is there an alternative?

As an alternative, your gearing option may be through the use of instalment warrants. These are effectively individual loans against underlying shares. They offer the flexibility of being able to exit or close out some loans and leave others open, which would offer you the flexibility to meet liquidity needs without the need to completely exit all gearing arrangements at the one time.

However, as instalment warrants involve an investment in underlying shares, they are usually subject to a greater level of volatility than property, which again means that you may be required to sell at a time which is not ideal. In some situations, the warrant may provide protection against the downside, but this comes at a cost, which could result in the interest cost on the loans associated with these investments being greater than applying to property loans.

Finally, are you aware of what you can and can't do with the investment?

This is most relevant where the geared investment is a property. There are very strict rules around what you can and can't do with a geared property. This isn't about who the property can be leased to, as normal super rules apply here (such as residential properties can't be leased to a related party).

Rather, it's about repairs, maintenance and improvements. Repairs and maintenance can be funded from the loan proceeds. Improvements can be made, but not with the borrowed funds, so the SMSF would need to have available cash to effect these improvements. And it's then important that the improvements aren't to the extent that the nature of the asset changes, as this would actually require repayment of the loan first. An example of this is where vacant land is purchased with borrowed funds. If the intent was to build a property on the land, this could not be done whilst the loan remains against the land.

Consider all the options to make the right decision

At the end of the day, this all highlights why gearing within an SMSF shouldn't be undertaken lightly. The best results come where you get your professional planners to work together and work with you to ensure your goals are achieved in the best possible way.

Whilst the Government has turned off the red light when it comes to SMSF gearing, this shouldn't be taken as giving the green light. The best view is that the amber light continues to shine brightly – pause, look around and consider your options before making the right decision.

Speak to your financial planner to discuss your SMSF investment options.

Source: BT

Making sense of the fixed income landscape

Fixed income in a portfolio can provide liquidity, regular income and diversify away from risk in shares. Essentially, fixed income assets should provide some certainty and predictability, which can be the defensive anchor of a portfolio.

There are many income funds available for investment, each with different underlying investments and often with similar names. It can be difficult to understand the risks, and the market conditions in which they perform well and those in which they don't.

To understand how fixed income can play a defensive role in a portfolio, investors must first go back to the basic principles of fixed income investing.

Income investing fundamentals

Investors in fixed income are lenders of capital. It is this basic principle which determines the risk and return characteristics of the asset class.

Essentially all bond investments are based around an investor lending capital to a borrower and it is the terms of this loan which determine the nature of the investment and, most importantly, whether that investment will meet their objectives in terms of defensiveness, liquidity and income.

A bond investor (either directly or via a bond or income fund) lends a known amount of capital to the borrower over a specific term in return for interest payments (or coupons) and repayment of the loan at some specific point in the future (face value of the bond).

When lending money, the risk and therefore likely return, is dependent on a number of key variables. Most importantly, your exposure to interest rates (duration), the risk associated with who you are lending to (credit risk) and how long you are lending for (maturity).

Duration

A lender typically has two options when it comes to the income they receive for providing a loan: fixed rates or variable rates. Duration is just the technical term to describe how the value of the loan moves when official interest rates move.

The higher the duration, the more the value of the loan will vary with interest rates. For example, if you have lent at a fixed interest rate and official rates fall, that loan becomes more valuable.

Similarly, when interest rates are low and rising, the value of fixed rate loans fall; after all, why would lenders lock in a rate when they could be rewarded with higher interest rates in the future?

Credit risk

The most significant risk for any lender is that the borrower defaults, ie they are unable to meet interest and/or capital repayments.

The most secure lenders are typically considered to be governments around the world and the best sovereign debt is considered to be almost risk free, eg lending to the Australian Government.

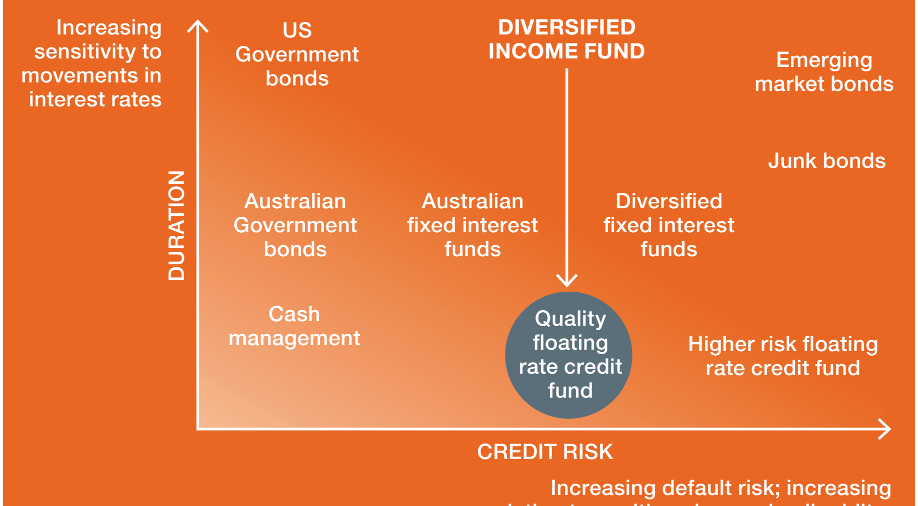
There is an extremely large universe of other borrowers from high quality through to what is considered higher risk, such as high-yield borrowers who issue what is known as sub-investment grade debt.

When you lend, the trade-off between risk and return can be very transparent. Taking more credit risk can lead to higher yield but it also leads to more risk.

Higher credit risk means the more likely that borrowers will not repay their capital, the more likely the loan value will correlate with shares and the less defensive the assets become.

Duration and credit risk are further illustrated in Chart 1.

Chart 1: The Lending Market Landscape



Source: Bloomberg, Reserve Bank of Australia.

There are many contributors to credit risk, such as the industry in which the borrower operates, the credit rating, whether the loan is secured by assets or unsecured and whether the loan is senior or subordinated to other creditors.

Maturity

How long money is lent for is also critical in determining risk. After all, there is more certainty about a borrower's ability to repay in the short term, and increasing uncertainty as the loan term increases.

The weighted average life (WAL) is the average number of years for which each dollar of unpaid principal on a loan or mortgage remains outstanding. It tells us how many years it will take to repay half of the outstanding principal.

The longer the WAL, the more volatile a bond portfolio is likely to be, and the more correlated with shares it will be. Therefore, longer maturity bond portfolios tend to provide fewer defensive characteristics for investors.

Where to now for fixed income investors?

Credit spreads, that is the returns provided for accepting credit risk, are currently at reasonable levels. We consider the current investment climate relatively supportive to holding credit risk in portfolios.

Cash and term deposit rates are still low, and government bond yields remain at or close to record lows. In fact globally, currently a substantial number of government bonds on issue are actually priced with negative nominal yields.

Fixed rate exposure isn't cheap and the interest rate duration of most bond indices has continued to lengthen. The risk is on the downside if rates begin to rise. While a well-constructed fixed income portfolio should have elements of both interest rate and credit risk strategies as sources of potential return, a bias to short duration credit in portfolios may well be prudent tilts to hold in the current climate.

Speak to your financial planner today for more information about building your fixed income portfolio.

Source: Perpetual Investments

Time to reconsider emerging markets?

After a prolonged period of market volatility, the news from emerging markets has taken on a more positive tone since the start of 2016. For example, the economic reports from China have been more encouraging, with import and export data improving in March and first quarter GDP growth meeting expectations at 6.7 per cent. Even Brazil, one of the worst performing markets in 2015, has improved, helped in part by the recovery in key commodity prices.

However, investors in general remain cautious. China's economic growth rate continues to slow and while the transition towards a more sustainable and balanced economy looks promising, the journey may be bumpy. A stronger US dollar has also traditionally weighed on emerging market returns, though the more cautious approach by the US Federal Reserve towards raising rates has seen that particular headwind diminish.

This has made the decision for investors more challenging. While the overall growth potential from emerging markets remains attractive and the current valuations, especially relative to developed markets, are appealing, the investor is left wondering whether now is the right time to commit. A key challenge remains around the inherent volatility in the asset class, and the preference for a reasonably clear investment horizon.

One solution is to identify a manager that can participate in the long-term growth potential while at the same time helping to mitigate that inherent volatility. One such strategy is investing in emerging market stocks that offer both capital growth potential as well as higher than average dividend yields. Over the last 20 years, dividend yield has been an important component of total return in emerging markets and also introduces some defensive characteristics into the portfolio, making this strategy an attractive long-term proposition.

To discuss your investment options, speak to your financial planner.

Source: Zurich

Getting financially prepared to start a family

Having a baby is a wonderful experience, but are you financially ready for it?

Before you have children, it's important to get your finances in order. Figure out how long you'll need off work and what Government support you're entitled to. Be sure to make a savings plan, get the right insurance and find ways to boost your super.

Thinking of starting a family in the next couple of years? Make sure your finances are in order first.

Before you start choosing names and browsing for strollers, here are seven steps to prepare you for the financial commitment of having a baby.

1. Calculate your time off work

To start, figure out how long you and your partner want to take off work to care for your little one. Consider whether you're planning to drop down to part-time hours during your baby's first years.

2. Know your entitlements

Next, look at what kinds of financial support you're eligible for. If you're going to be the child's primary carer and you fit other criteria, you could be entitled to up to 18 weeks' paid parental leave from the Federal Government — even if you're a seasonal employee, contractor or self-employed

Other income support schemes for families include the Parenting Payment and Family Tax Benefits. Find out what you're entitled to, based on your financial circumstances.

3. Make a budget

Once you've decided how much time off you're likely to take and the extra income support you can expect, make a household budget. Work out your current expenses and add in the additional costs of raising a child. Then, compare it with how much money you'll have coming in. If there's a difference, you'll need to start putting away some extra money now.

Source: Colonial First State

4. Start saving

It's never too early to start saving for your child's future. You're bound to have some extra expenses in the short term, so it could be worth opening a higher interest savings account or term deposit to help save for those.

You might also want to talk to a financial planner about longer-term saving and investment strategies — especially for big-ticket costs down the track like your child's education. Options may include investing in shares or managed funds, or paying more off your mortgage now to free up your money later.

5. Sort out your health insurance

Next to education, healthcare could be one of your biggest expenses, so make sure you and your partner have the right level of health insurance. Some couples realise too late that their policy doesn't cover pregnancy-related expenses, and then they have to face a waiting period of up to 12 months after they increase their cover.

6. Don't forget personal insurance

To protect your family financially, consider taking out income protection insurance. That way, if you get sick or injured and have to take time off work, you could still have money coming in while you get back on your feet. Another important one is life insurance, which could pay your family a lump sum if you pass away or become terminally ill.

If you're worried about the added expense of insurance premiums, don't despair. You can take out both life and income protection insurance through your super, so you don't have to cover the costs from your household income.

7. Boost your super

That brings us to a very important consideration — how to keep building your super if you're taking time off work. One option is to salary sacrifice part of your income into super now. And if you, or your partner, is planning to take time off while the other keeps working, splitting your super contributions can offer potential tax advantages.

Getting professional advice can help take the worry out of starting a family — so talk to your financial planner today.

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