

e-Newsletter April 2015

## *Ongoing stimulus gives markets cause for optimism*

by **Jeff Mitchell**, Head of Investment Research, Australian Unity Personal Financial Services

So far in 2015 we have seen growing evidence and indeed the appearance of growing conviction that interest rates (government bond rates and by default term deposits and high credit quality instruments) are likely to stay lower for longer.

With this as a back drop, lower oil prices and ongoing fiscal and monetary stimulus have acted to buoy asset markets globally.

Global equity markets have rallied, driven in part by the US Federal Reserve moving tantalisingly closer to increasing the Fed Funds rate (seen as confirmation by the Fed that GDP growth is occurring on a sustainable basis) for the first time since 2006. Data for US employment growth, seen as a pre-condition for rates to rise later in the year, rose in the earlier months of 2015.

Further, the European Central Bank announced a one trillion Euro bond buying program in a concerted effort to stimulate growth in the flagging Eurozone.

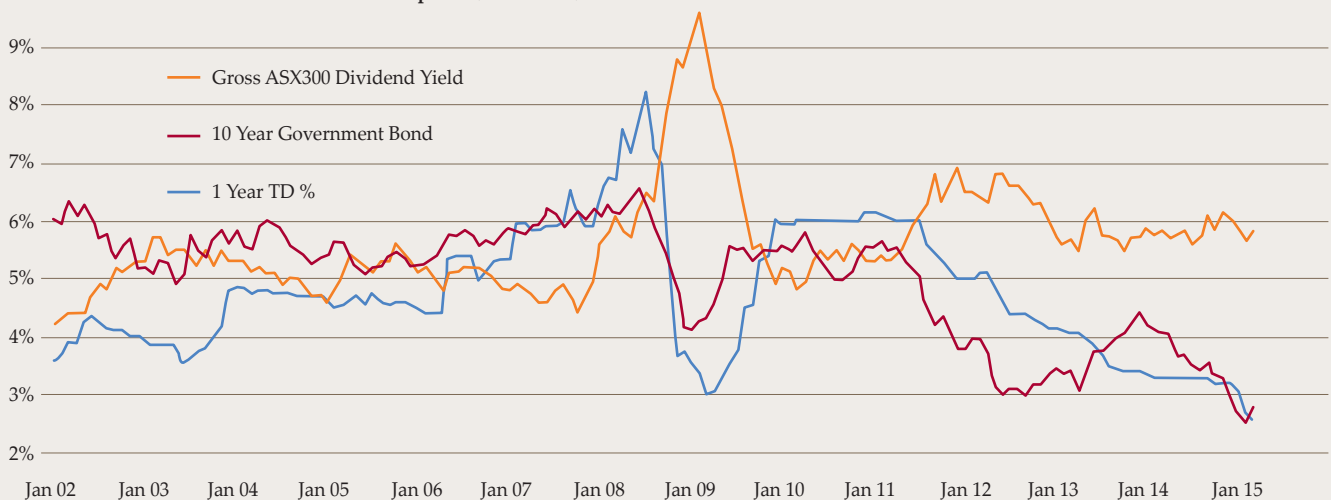
In Japan, Prime Minister Abe continues with a set of stimulatory reforms which appears to be inching Japan out of its two decade malaise.

In China GDP growth has continued to slow modestly but is still running at a level near 7.0% p.a. The Chinese authorities are seeking to transition the world's second largest economy from being predominantly export driven to one where domestic consumption plays a meaningful role. This process is creating cultural challenges as state owned enterprises and regional governments are being held accountable for their financial management.

In addition authorities are also addressing endemic corruption to promote transparency and confidence in the administrative system.

China continues its accommodative stance on monetary and fiscal policy and efforts to boost cross border trade flows have assisted the continuation of the Chinese equity market

**Chart 1: Australian Shares v Bonds v Term Deposits (2002 – 2015)**



Page 1

rally which has risen over 17% in 2015 and 78% over the past 12 months after several years of lacklustre performance.

In Australia a similar story for the share market performance unfolded with shares receiving a boost from an RBA rate cut in February. This was a fillip to a market that is receiving longer term support courtesy of its attractive dividend yields as income hungry investors bid up the prices of the higher yielding key financial and industrial stocks such as the 'Big Banks' and Telstra.

The countervailing force to this has resulted from the ongoing decline in global commodity prices, particularly iron ore, which has negatively affected the large resources sector of the Australian market. This was typified by Fortescue's failed bond raising in March as investors were not enticed by the yield being offered and remained concerned as the iron ore price falls perilously close to Fortescue's breakeven cost of production. Other junior miners such as Atlas Iron have fared even worse.

Investors have become a little more sanguine about the macroeconomic environment and this, coupled with the prospect of an extended period of lower interest rates, has seen equities attract disenfranchised bond holders to share markets in search of yield which is adding further support to prices.

### With this scenario being the likely back drop for the coming years, how will it affect portfolio returns?

With interest rates on Australian government bonds remaining low then, all other things being equal, yields

on other assets (e.g. property and shares) can be expected to also adjust proportionately. In which case, if corporate earnings are not overly impacted and, in aggregate we do not expect they will be, then for the yield from shares to fall, their prices will need to rise.

This is demonstrated in Chart 1 (*previous page*) showing Australian share dividend yields (yellow line) being significantly higher than bond yields. As presented the gap between the two has seldom been larger and if normal market conditions prevail and interest rates stay lower then it is likely that equity yields will fall as the result of prices rising.

Recent rallies in US shares have meant that the spread between US bond yields and equity yields has narrowed. The coming earnings reporting season will be of particular interest to see if the higher prices justify the earnings multiples.

### Australian shares and property have been strong recently

The Australian share market has been quite strong since its minor correction in October 2014, with gains encapsulating a number of positive factors: the apparent sustainable recovery in the US; a general increase in desire for risk assets as investors become more positive about the global economy; and an upward adjustment in equity prices to reflect the relative attractiveness of their yields relative to lower yielding bonds.

The property market has been similarly affected, particularly Listed Property Trusts (LPT), whose prices have risen to adjust yields downward to re-establish historical yield premia relationships to bonds.

### Tippling Point table suggests most major assets are cheap to fair value

Australian Equities			Developed Market Equities			Emerging Markets			Australian REITs		
All Ords Index	Forecast return	Status	S&P 500	Forecast return	Status	FTSE EM (Local)	Forecast return	Status	ASX REIT Index	Forecast return	Status
8750	3.6%	Fully priced	2700	3.9%	Fully priced	1050	2.6%	Overpriced	1650	3.6%	Fully priced
8500	4.0%	Fully priced	2600	4.4%	Fully priced	1000	3.1%	Overpriced	1600	4.1%	Fully priced
8250	4.4%	Fully priced	2500	4.8%	Fully priced	950	3.7%	Fully priced	1550	4.5%	Fully priced
8000	4.8%	Fully priced	2400	5.3%	Fully priced	900	4.3%	Fully priced	1500	5.0%	Fully priced
7750	5.3%	Fully priced	2300	5.8%	Fully priced	850	5.0%	Fully priced	1450	5.4%	Fully priced
7500	5.7%	Fully priced	2200	6.4%	Fair value	825	5.4%	Fully priced	1400	5.9%	Fully priced
7250	6.2%	Fair value	2100	6.9%	Fair value	800	5.7%	Fully priced	1350	6.5%	Fair value
7000	6.7%	Fair value	2050	7.2%	Fair value	775	6.1%	Fair value	1325	6.7%	Fair value
6750	7.2%	Fair value	2000	7.5%	Fair value	750	6.5%	Fair value	1300	7.0%	Fair value
6500	7.8%	Fair value	1950	7.9%	Fair value	725	6.9%	Fair value	1275	7.3%	Fair value
6400	8.0%	Fair value	1900	8.2%	Fair value	700	7.4%	Fair value	1250	7.6%	Fair value
6300	8.3%	Fair value	1850	8.5%	Fair value	675	7.8%	Fair value	1225	7.9%	Fair value
6200	8.5%	Fair value	1800	8.9%	Cheap	650	8.3%	Fair value	1200	8.2%	Fair value
6100	8.8%	Cheap	1750	9.2%	Cheap	625	8.8%	Cheap	1175	8.6%	Fair value
6000	9.0%	Cheap	1700	9.6%	Cheap	600	9.3%	Cheap	1150	8.9%	Cheap
5900	9.3%	Cheap	1650	10.0%	Cheap	575	9.9%	Cheap	1125	9.2%	Cheap
5800	9.5%	Cheap	1600	10.4%	Cheap	550	10.4%	Cheap	1100	9.6%	Cheap

➡ US   ➡ Rest of World

Source: Farrelly's Asset Allocation as at April 2015

The Australian residential property market is also caught up in the impact lower rates are having, pushing property prices higher as buyers are able to service larger loans with available income.

### **Long term expectations for interest rates reduced**

After a review of global macroeconomic conditions and forecasts in relation to the level of government bond rates, and by association high quality fixed interest such as term deposits, we have, in line with current market forecasts taken the step to reduce our long term expectations for interest rates. This reduction is now incorporated in our Tipping Point table (*previous page*).

The obvious effect of reducing our long term term deposit rates forecast is that it increases the levels of the respective valuation bands for growth assets i.e. prices can rise further before they become expensive relative to term deposits. So this recalibration of the inputs to the Tipping Points table has, in effect, given more headroom for markets to rise before they approach 'fully' or 'overvalued' levels.

From a portfolio positioning perspective we remain overweight to Australian shares relative to global shares. Within global shares we retain an overweight to selected emerging markets, being the most attractively valued, at the expense of the now 'fully priced' US market.

In relation to property, the Australian LPTs, in aggregate, have seen a substantial rally in prices. The S&P ASX 200 Property Index has risen approximately 8.5% year to date,

and while still showing as 'fair value', will soon be flirting with being 'fully priced' if the present trend continues. We have a preference for select diversified unlisted property at the moment as the valuations are more attractive, however liquidity can be an issue with these investments.

### **Conclusion – we remain optimistic about long term returns from most assets**

In summary, we are comfortable for portfolios to be fully invested in accordance with recommended portfolio asset allocations. The changes to our long term forecasts for term deposit rates have provided us more comfort in relation to present valuations in the context of the coming decade.

As we all know, there will be bumps along the way as markets will routinely experience rallies and declines in prices.

However, maintaining a focus on long term value and quality assets provides confidence that the allocations of capital are appropriate.

Because market prices can fall victim to investor sentiment for extended periods of time, it is important to maintain a process of measured adjustment when required. Expensive assets can get more expensive and cheap assets can get cheaper.

Taking a measured approach to portfolio adjustments to smooth the vagaries of the market has proved to be prudent over the longer term.

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## What is our approach to *asset allocation*?

The objective of our unique approach to asset allocation is to help you minimise investment risk... and increase the long term return on your portfolio.

Our approach is based on the philosophy that:

### **Buying quality assets at reasonable prices is the best way to achieve competitive long term returns**

It is important to note we do not try to predict when an expensive asset class will begin to fall in price or when a cheap asset will rise in price. Cheap assets can become even cheaper. Expensive assets can become even more expensive.

The turnaround may be just months away or it could be a few years away. No one knows exactly when that turnaround will be. For this reason we advise buying cheap assets slowly and selling expensive assets slowly. This gives you the chance to benefit from buying at even cheaper prices or selling at even higher prices.

We do not recommend buying overpriced assets just because you have money to invest. Our goal is to buy at lower prices – even if that means you have to wait before all of your money is invested.

### **The benefits of our approach**

There are many benefits that can come from our approach, including:

- Stronger, smoother and more predictable long term returns from your portfolio
- Reduction in your exposure to overpriced assets... and therefore less exposure to significant market falls and bear markets
- Increased exposure to rising markets.

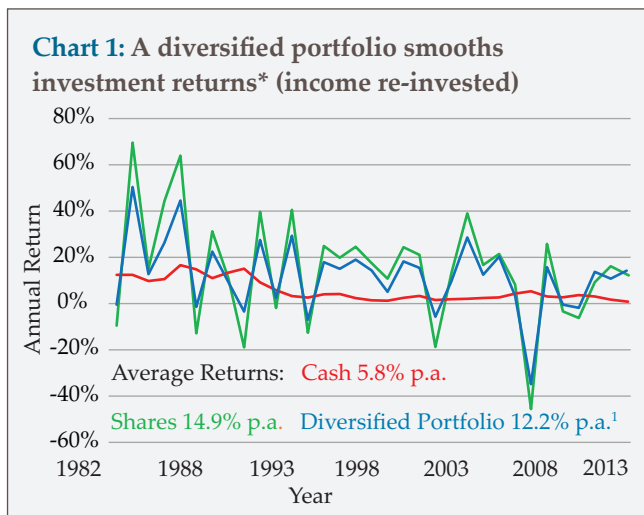
# How a *Diversified Portfolio* can reduce risk... and *increase returns*

A diversified portfolio helps reduce investment risk in two main ways:

- Investment in a broad range of securities lessens the impact on a portfolio of one security failing.
- Investment across the major asset classes tends to smooth the overall portfolio returns, because while one asset class is in a downturn other asset classes can be performing well.

A diversified portfolio also gives you access to the potentially higher returns from quality shares and property combined with the security of fixed interest and cash.

This can be seen in Chart 1 which compares the volatility and long term returns of shares versus cash versus a broadly diversified portfolio. As you can see, the latter has generated higher returns than cash with less volatility than shares.



\*Sources: 1 Jan 1982 – 1 Jan 2015

Cash: RBA cash management accounts at banks (\$10,000). Term Deposits: RBA Stats Banks' fixed deposits (\$10,000). Shares: The All Industrials Accumulation Index to 31/12/01 and the S&P/ASX XNJA1 thereafter. Property: The S&P/ASX 200 Property Accumulation Index. Diversified<sup>1</sup>: Portfolio based on 50% shares, 25% property, 5% cash, 20% term deposits. Note: Tax and fees are not taken into consideration. Income is re-invested. Past performance is not an indicator of future performance.

## Case study

Let's say you and your spouse have \$100,000 to invest on 1 January 1982.

Chart 2 shows how much wealth you may have created by investing in certain assets by January 2015, assuming income was re-invested.

As you can see, if you had invested your money into term deposits, it would have grown to \$931,615.

But if you had invested in a diversified portfolio<sup>1</sup>, you would have \$3,232,447. It's a \$2,300,832 improvement.

A diversified portfolio invests in each of the major asset classes, in proportions that suit the risk & return profile of the investor.

The major asset classes are shares, property, fixed interest and cash. A well diversified portfolio usually invests in a number of securities in each asset class, directly and/or via managed funds, and may invest in Australia and overseas.

Now let's assume you retired at the start of 2015. What would be your investment income position?

Your diversified portfolio would be generating an income of something like \$144,657 this year (based on last year's income). On this, you and your spouse could expect to pay tax of \$8,684 (as shown in Table 1).

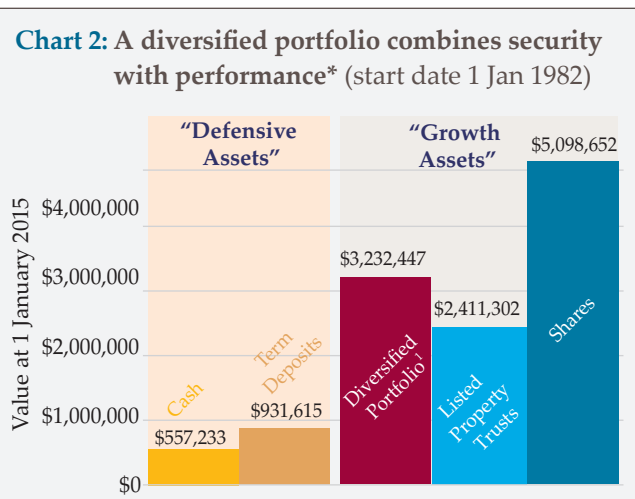
Compare that to the \$31,675 net income you would receive from term deposits this year (based on last year's income).

**Table 1: Retire 1 Jan 2015 after investing \$100,000 on 1 January 1982\***

	Diversified Portfolio <sup>1</sup>	Term Deposits
Capital value	\$3,232,447	\$931,615
Expected income (based on last year's yield)	\$144,657	\$31,675
Tax on income**	\$8,684	\$0
<b>Net Income</b>	<b>\$135,973</b>	<b>\$31,675</b>

<sup>1</sup> Portfolio based on 50% shares, 25% property, 5% cash, 20% term deposits. Past performance is not an indicator of future performance.

\*\* Assumes income splitting with a spouse and no other assessable income for income tax calculation purposes. Shares 80% franked. Income not re-invested in retirement. Tax rates 2014/15



# Unexpected news is derailing the *retirement plans of Australians: Survey*

Australians are not as in control of when we will retire as we may like, with research from Mercer\* revealing 40% of Australians were forced into retirement due to redundancy or illness before they were financially ready.

Another 24% retired with insufficient savings.

As a result, most Australians outlive their retirement savings by at least five years, the research found.

If you were to retire at age 60 you will need to fund a retirement, on average, of around 25 years based on life expectancy tables produced by the Government.

However, Mercer's research reveals that if you are a white-collar worker there's a high chance you'll live much longer than the average person and have to fund a retirement of around 35 years.

The message here is that you need to take control of your retirement plans as soon as possible, including the need for you to protect your ability to earn an income by purchasing appropriate insurances such as life cover, income protection and trauma insurance.

You also need to build a capital base large enough to fund your lifestyle requirements for your entire retirement.

One strategy to help you to achieve that goal is to optimise your superannuation contributions.

That's because superannuation is still the most tax effective way to save for retirement.

It's not the only strategy, however, which is why you should consult regularly with your financial adviser to find out how you are tracking against your retirement savings goals and what, if anything, you need to do to boost or protect your savings.

**Life Expectancy Table**  
Australia, 2011 - 2013, Australian Bureau of Statistics

	Male Expectancy (years)	Female Expectancy (years)
<b>Age</b>		
25	55.8	59.9
30	51.0	55.0
35	46.2	50.1
40	41.5	45.2
45	36.8	40.4
50	32.2	35.7
55	27.7	31.0
60	23.4	26.5
65	19.2	22.1
70	15.3	17.9

## How much can you invest in super this financial year?

Here are the superannuation contribution caps which apply for the 2014/15 financial year.

### • Contributions which qualify for a tax deduction

These are known as concessional contributions and the limit is aged based, as shown below. Generally you can only qualify for a tax deduction if you are self-employed.

However employees can benefit as well by making a contribution through salary sacrifice.

The limit includes any Super Guarantee your employer pays on your behalf.

Age	Tax deductible limit (2014/15)
Up to 49	\$30,000
50+	\$35,000

### • Contributions which do not qualify for a tax deduction

You could also invest up to \$180,000 p.a. in super as a non-concessional contribution (i.e. you do not receive a tax deduction on this contribution). If you are under age 65, you can 'bring forward' up to two years of non-concessional contributions. This means you could contribute \$540,000 in one financial year, but you would not be allowed to make non-concessional contributions in the following two financial years.

### • The Government co-contribution

Currently, eligible workers earning up to \$49,488 who make personal contributions to super can take advantage of the Government co-contribution of up to \$500.

### • Spouse contributions

If your partner's income is less than \$13,800, you could qualify for a tax offset of up to \$540 on the first \$3,000 you contribute to superannuation for them from your after-tax income. This tax offset decreases as your partner's income increases above \$10,800.

## Caution: 40% of Australians forced into unplanned early retirements\*

- 40% retire due to illness or redundancy and of these people most are not ready financially
- Another 24% retire with insufficient savings
- Most retirees outlive their savings by at least 5 years

**Lessons: Fast track your retirement savings plans and purchase income protection and trauma insurance**

\* Mercer Survey 'Expectations Vs Reality of Retirement' 9 October 2014

# Buying a home? *Or looking to re-finance?* Check out our low interest rate!

One of the best ways to save money on your home loan is to make sure you have a competitive interest rate for the type of loan you need.

That's why Australian Unity Home has negotiated with leading lenders to give us access to some of the cheapest loans on the market.

For example, our award-winning variable home loan currently has an interest rate of just 4.48% p.a. (comparison rate of 4.50%), which is one of Australia's lowest variable interest rates.

And it has no monthly or annual fees.

In addition, it offers a free valuation on application for the loan, unlimited free redraws, and unlimited extra repayments.

Plus this loan is rated the full 5 stars and 'outstanding value' by Canstar\*. This loan is available for loans between \$200,000 - \$499,000.



## Home Loan

\*Canstar is a financial data provider. Refer to <http://www.canstar.com.au/wp-content/uploads/2014/02/HL-Methodology-Sept-13.pdf> for a description of its home loan ratings methodology. †The information used for this comparison is accurate as at the date of this publication, and may be subject to change. Comparison rate based on a secured home loan of \$150,000 over a 25 year period.

**WARNING:** This comparison rate applies only to the example or examples given. Different amounts and terms will result in different comparison rates. Costs such as redraw fees or early repayment fees, and cost savings such as fee waivers, are not included in the comparison rate but may influence the costs of the home loan.

\*Australian Unity Personal Financial Services Ltd markets and provides credit services in relation to Australian Unity Home Loans - Australian Unity is not the credit provider. The credit provider of Australian Unity Home Loans is AFSH Nominees Pty Ltd ACN 143 937 437 Australian Credit Licence 391192.

**“Our award-winning variable home loan currently has an interest rate of just 4.48% p.a. (comparison rate of 4.50%), which is one of Australia’s lowest variable interest rates.”**

## Small interest rate savings can make a big difference

Here's a real life example of why it pays to find a lower interest rate on your home loan.

A major bank is currently charging 4.83% p.a. (comparison rate of 5.18% p.a.) for their basic variable home loan, compared to our 4.48% (comparison rate of 4.50% p.a.). It doesn't seem like much of a difference, but as you will see below, those savings add up over time. If you had the major bank's loan, the default repayment on a \$350,000 loan would be \$1,843 per month, and your interest bill and ongoing fees over the 30 year loan would be \$324,615.

However, if you switched to an Australian Unity home loan<sup>†</sup>, your monthly repayments would reduce to \$1,770 per month. If, however, you maintained your original \$1,843 monthly repayments, your interest bill (we have no ongoing fees) over the life of the loan with Australian Unity would be just \$261,019 – a saving of \$63,596 and you would repay your loan 2.4 years sooner<sup>‡</sup>.

That's not a bad return for just switching your home loan. So call your adviser today to find out how you can make the switch and save.

# Aged 55+ *and in the workforce?*

Special rules mean you could start paying a lot less tax... and at the same time build your superannuation balance faster.

To find out if you qualify, please talk with your financial adviser

# Survey: Majority of SMSF members do not hold life insurance cover

Almost 85 per cent of self managed super fund (SMSF) members aged 18 to 64 do not hold life insurance cover, new research from Plan for Life\* has revealed.

This is despite legislation enacted more than a year ago which says SMSF trustees now have an obligation to consider the need to hold insurance cover for their members.

Of course, many SMSF members do not hold life insurance cover in their SMSF because they hold it elsewhere, or because they are self funded and do not need life insurance.

Nonetheless, there is no doubt this survey suggests there is a significant number of SMSF members who have little or no life insurance, but should.

This is particularly the case where the person has dependants and/or debt, or if they have a business partner.

## Should you review your life insurance position?

Find out if your family would be financially vulnerable – if you were to suffer a serious illness or injury, or if you died – by taking this quick quiz.

\*Reported in IFA magazine, 15 January 2015

Would you be able to pay your living expenses in the event you could no longer work due to a serious illness or injury?	Y <input type="checkbox"/>	N <input type="checkbox"/>
Could you pay off all your debts (such as your mortgage) in the event you suffered a permanent disability or if you died?	Y <input type="checkbox"/>	N <input type="checkbox"/>
If you died, could your family afford to pay for their living expenses?	Y <input type="checkbox"/>	N <input type="checkbox"/>
Do you have a business partner? If they died, could you afford to buy their share of the business?	Y <input type="checkbox"/>	N <input type="checkbox"/>
If you died, could your business partner afford to pay your estate for your share in the business?	Y <input type="checkbox"/>	N <input type="checkbox"/>
If there is an individual in your business who is crucial to its success, is the business protected financially if that person had to leave the business due to serious illness or injury or death?	Y <input type="checkbox"/>	N <input type="checkbox"/>

**If you answered 'No' to any of these questions, we recommend you make an appointment to review your risk insurance position with one of our financial advisers.**

# Centrelink reduces deeming rates

From 20 March 2015, Centrelink reduced the deeming rates applicable to allowances and pensions.

The lower deeming rate fell from 2% to 1.75% for singles for financial investments of up to \$48,000 and for couples with investments of up to \$79,600.

The upper deeming rate reduced from 3.5% to 3.25% for amounts over the deeming threshold.

It is estimated Centrelink recipients will receive an average increase in benefit of \$83.20 a year.

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