

INFORMED INVESTOR

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FURTHER INFORMATION

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WELCOME

KEEPING YOU INFORMED

Welcome to the latest edition of our quarterly newsletter 'Informed Investor.'

In this issue we explore:

1. Constructing a retirement portfolio in a low return world
2. 5 money mistakes to avoid if you're going guarantor
3. Should you use property to fund your retirement?
4. How does your pension live on after you die?

As always, if you have any questions about the information contained in these articles or how certain aspects may apply to your personal situation please feel welcome to contact us.

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CONSTRUCTING A RETIREMENT PORTFOLIO IN A LOW RETURN WORLD

Portfolio construction is a much-used term that can be misunderstood.

Fundamentally, the term portfolio construction refers to the process of selecting investments to create the optimal balance of risk and return.

By mixing different types of investments and different asset classes, portfolios can be built in a way that maximises the return for any given level of risk.

This concept of risk is fundamental to portfolio construction. The key to effective portfolio construction is understanding that each individual experiences risk differently and investment needs change dramatically as people's priorities change over the course of a lifetime.

RISK TOLERANCE

Depending on what stage of life they are at, individual investors can have quite different goals.

An investor early in their career can afford to seek higher returns from their investment portfolio by taking a higher level of risk because they have more time to make back any downturns in markets.

They also have less need for income from their investments than someone approaching or in retirement and can weight their portfolio towards growth assets.

A younger investor can be less concerned about inflation than a retiree because they can rely on wages growth that can maintain their purchasing power.

They can also afford to lock up investments for a longer period without worrying about liquidity because they have time

before they need to draw down on their assets.

In contrast, retirees tend to be more concerned about capital preservation because they need to draw on their asset pool throughout their retirement.

As they are no longer earning income from work, they need to draw income from their portfolio. This means they should consider weighting their portfolios towards income-generating assets.

Any increase in inflation erodes a retiree's purchasing power as it costs more to maintain standard of living which means their capital can be eroded faster than planned.

And liquidity is critical for a retiree as assets may need to be sold quickly – for example if there is a medical emergency – without punitive valuations.

The concept of sequencing risk is also a critical difference between early and late-stage investors.

SEQUENCING RISK

Sequencing risk refers to the risk of being forced to sell investments after a fall in valuations.

A younger investor can typically ride out market volatility and even buy more assets when valuations are low.

However, late career investors and retirees who are forced to sell assets at low prices to fund their lifestyles have no way of regaining the lost value.

A sensible portfolio construction process can protect against this.

HEDGING RISK

A question that often comes up is the role of downside protection in portfolio construction. The answer is different depending on where an investor is at in their investing journey.

Take the example of a pre-retiree and a younger investor with portfolios split equally between equities and bonds going into the global financial crisis (GFC) – with and without downside protection using options strategies.

Without downside protection, the retiree would have seen a pullback in the value of their assets of about 25 per cent and, because they were drawing down on their assets to live their life, they would not have been able to fully participate in the subsequent recovery.

Had they used downside protection on their portfolio, they would have been back on track by 10 years later.

The same is not true of the same strategy deployed by a younger investor. Without downside protection, young investors just keep buying into the market through a downturn and continue to accumulate assets.

But with downside protection – which comes at a cost – they see a drag on their returns, lowering their ultimate savings. It's a reminder of the difference between younger and older investors.

Human beings also have the potential to make mistakes in their investing lives. If a retiree investor facing the same kind of GFC drawdowns suddenly became risk-averse and shifted their portfolio to 30:70 equities and bonds, this would be an understandable and apparently rational decision to preserve assets.

But markets recover. If that retiree waits until the storm passes and takes three to five years to switch back their allocation to 50:50, they would be 30 per cent worse off than if they did nothing at all.

ASSET ALLOCATION

So, what assets should retirees look for?

In our view, the key is to seek out desirable risk attributes and not simply take the approach of investing by asset class.

In Australian equities for example, franking credits offer a good income stream for retirees by refunding the tax paid by the underlying companies. It should also be noted, however, that in seeking a higher exposure to Australian equities in pursuit of franking credits, a portfolio will acquire other concentrations of risk, for example: exposure to China. Good portfolio construction should consider and diversify away these concentrations.

In direct assets, infrastructure offers good opportunities for retirees. Many infrastructure assets earn a return on an availability basis regardless of actual usage or economic conditions, providing a stable income.

The key consideration for direct assets is liquidity, as holding large allocations of illiquid assets could mean having to disproportionately sell down liquid assets, like equities, at an inopportune time if larger

sums of cash are needed for, say, a medical emergency.

For bonds, the traditional defensive characteristics may not be available in a world of near zero interest rates and the potential of rising inflation.

In the last 30-40 years we have seen a terrific run in markets, particularly with bond rates coming down from as high as 16.5 per cent in the case of 10 year Australian government bond yields almost 40 years ago to near zero now. The performance was further buoyed by lower tax rates, falling tariffs and the rise of globalisation.

The corollary of this is that throughout those 40 years, forward return expectations have been declining. In fact, a fund with a traditional asset allocation split 60:40 between equities and bonds is near its highest ever valuation level.

We believe this means return expectations from investment portfolios should be expected to be lower going forward until interest rates normalise.

Inflation is also a looming threat to portfolios. US annual consumer price inflation pushed up beyond 6 per cent in October of 2021 and there is a risk that price pressures associated with deglobalisation and decarbonisation defy the widely held 'transitory' thesis and stick around.

GOALS-BASED INVESTING

Given lower expected returns and higher inflation, what's the right portfolio response?

Doing nothing is one approach – simply accept that returns are going to be lower. Another approach is to increase risk – adding riskier, more leveraged asset classes will improve the prob-

ability of getting a return but also increase the probability of losing money.

A third approach is to lower your expectations. This means not changing how portfolios are constructed but accepting the likelihood of lower returns and perhaps adjusting things elsewhere in your life accordingly. In our view, this isn't of much use or comfort however to today's pre-retirees and retirees.

And the final – and more important – approach is to adjust strategy to those areas most likely to achieve objectives. This could include taking a goals-based approach to investing.

For example, a retiree could decide that rather than taking a traditional asset allocation approach to portfolio construction, they instead want to take on the goal of protecting and maintaining their standard of living in retirement. That goal might be measured by providing returns equal to the consumer price index plus 3.5 per cent as an example.

By focusing on the desired outcomes rather than simply considering traditional asset class allocations, investors can consider including alternative investments and strategies that may not be available under a traditional approach.

Source: AMP Capital



5 MONEY MISTAKES TO AVOID IF YOU'RE GOING GUARANTOR

If you're going to balance the future of your home on someone's ability to pay their own mortgage, make sure you're across the risks.

Nearly 40% of Aussies said it took them between two and five years to save for a deposit on a home, while 25% said it took them between five and 10 years.

If you have a family member who wants to get into the market sooner than that, you may have discussed whether you'd be willing to speed up the process (if you're in a position to) by going guarantor. This is where you use the equity in your own property as security for the loan they're taking out. It's essentially a promise by you (the guarantor) to the lender, that the borrower will make the necessary repayments and if they don't, or are unable to, you'll repay the loan for them.

While there may be benefits for the person you're going guarantor for (they mightn't need such a big deposit or could avoid paying lenders mortgage insurance), here are some things to avoid before making a decision.

NOT KNOWING WHAT YOU'RE SIGNING UP FOR

Depending on the lender (and each will have their own terms and conditions if they allow for this type of arrangement), you can use your property as security on someone's entire home loan, the entire loan amount plus additional costs, or limit the guarantee to a portion of the loan.

The role of guarantor will generally be limited to immediate family members, but may include siblings, grandparents and even former spouses, depending on your lender.

Meanwhile, how long you act as guarantor will depend, but once this person's loan has reduced beyond a certain level, you can ask to be removed as guarantor, although this will have to be approved by the lender and fees may apply.

NOT CONSIDERING CHANGES IN CIRCUMSTANCES

You always want to hope for the best but over the term of this person's home loan, there could be a point where they lose their job or become injured or ill and be unable to make repayments for a while. For this reason, you may want to find out if they have a back-up plan, any emergency cash stashed away or personal insurance (what type and how much).

If things don't go as expected, repayment of their home loan becomes your responsibility, so unless you have additional funds, worse-case scenario, you may have to sell your home to clear this person's debt and there could also be flow on affects regarding your credit report.

NOT GIVING MUCH THOUGHT TO YOUR OWN BUCKET LIST

Going guarantor reduces your ability to borrow funds, so it's important to think about whether you have other plans that could be affected – such as holidays or other big purchases.

You may also want to give some thought to your retirement. June 2021 figures (which assume you own your home outright and are pretty healthy) show individuals and couples, around age 67, who are looking to retire today, need an annual budget of around \$44,818 and \$63,352 respectively to fund a comfortable lifestyle.

With that in mind, you don't want a sudden liability, such as being called on as guarantor, to jeopardise your retirement plans.

NOT EXPRESSING YOUR EXPECTATIONS

Before making any decisions, it's important to discuss and consider:

- Both parties' circumstances and expectations over the life of the loan.
- Having an agreement in place to help make sure everyone is on the same page.
- How long you expect to be involved and what your exit strategy as guarantor might be.

NOT EXPLORING OTHER FINANCIAL AVENUES

There may be other financial avenues that could work better for you and the borrower depending on your situation.

Could you gift a deposit?

If you can afford it, gifting a deposit might be something you'd prefer to do. A good deposit will reduce the amount your family member needs to borrow, and the interest paid over the life of their loan. Going down this avenue also means any loss you incur will be limited to the amount of the gift.

Bear in mind, if you happen to receive Centrelink payments (or are planning to in the future), you'll need to consider that a gift of this nature could impact your benefits, so do your research.

Could you go in as a co-owner?

When you buy a home with family members, you share responsibility for the costs involved while receiving the benefits of investing in property, depending on your arrangements. It's important to understand that as a co-owner you are included on the loan and only own a share of the property. If you sign as a joint borrower, you're also equally responsible for the home loan so are equally liable for the entire debt with the principal borrower.



Again, it's a good idea to document each person's rights and obligations. For example, is the person who is going to live in the property going to pay you rent, which you would otherwise expect in an investment property situation?

Going in as a co-owner is a big commitment and you'll need to understand the risks and get the right advice, so you're across everything, including tax and possible Centrelink issues.

Could you let them save money by living with you?

If it's your child you're thinking about going guarantor for, you may be interested to know that many parents have adult children living at home rent-free to help them save for a home.

With that in mind, you may prefer offering your child their old room for a while for low or no rent to help them get some more savings behind them.

WHERE TO GO IF YOU NEED A BIT OF HELP

Acting as a guarantor is a serious legal responsibility and you may be required to get legal advice before a lender will accept the arrangement. It's also a good idea to discuss any potential risks, benefits and tax implications with your financial adviser as well.

Source: AMP



SHOULD YOU USE PROPERTY TO FUND YOUR RETIREMENT?

While property may seem like a good way to build and hold wealth, is it a practical way to fund your retirement?

Superannuation, shares, property, cash, other investments; a dizzying number of options are available when it comes to living comfortably through retirement.

Financial advisers often promote a diversified portfolio to reduce the risk of concentrating 'all eggs in one basket'. Still, Aussies love their property, with more than 2.2 million of us opting for investing in property, with almost 60% of those aged 50 or over holding property investments.

Aside from simply owning a secure place to live through retirement, investing in property can also provide regular post-work income and might offer some assurance as a 'safe' investment option. Property is a physical asset and can seem less volatile than other investments, particularly when heading into a phase of life that holds uncertainty and where you may think: "What happens if I outlive my savings?"

But different risks and tax obligations in retirement can alter the attractiveness of investments and, when it comes to property, there are a range of strategies that offer different pros and cons when using it to fund retirement.

LIVING OFF RENTAL INCOME FROM AN INVESTMENT PROPERTY

On the surface, living off rental income in your retirement is an attractive prospect. But you may need to first make sure the lifestyle you want doesn't exceed your investment property's returns, taking into consideration any mortgage repayments, taxes and maintenance costs, as well as factoring in for times when the property may not have tenants.

Many people find they need multiple properties in their investment property portfolio to generate enough income to support their retirement lifestyle.

PROS OF LIVING OFF RENTAL INCOME

Capital appreciation:

If you've owned a property for a while or have made significant improvements, chances are it may have grown in value – and may continue to do so. Growth in value can also mean higher rental rates and returns.

Interest rates are at all-time lows:

Which means low mortgage repayments, if you have them.

Outgoings can be low:

If you're healthy and handy, you can leverage your free time in retirement to save maintenance costs by doing your own property management and minor repairs.

Holiday ahoy:

Many Australians choose to purchase investment properties in holiday locations. When leased, your tenants provide an income stream; when not, you have an instant holiday house for yourself or perhaps a short-term rental.

CONS OF LIVING OFF RENTAL INCOME

Ongoing costs can pile up:

In addition to anticipated outlays – property management, insurance and rates – you risk unexpected costs like emergency repairs and oft-forgotten long-term appliance or structural replacements.

Income from your investment property may be subject to income tax:

This will depend on the net amount per financial year – and the amount and type of any other income.

Liquidity is restricted:

If you need funds unexpectedly e.g. for medical costs, to take a holiday, or for emergencies, you can't sell a single room of your investment property as you can with shares of stock – the whole thing has to go, and it will take some time before you get the actual sale proceeds.

Your income isn't guaranteed:

The rental market can change, and it might mean that your property can be empty for periods of time.

LIVING OFF EQUITY

This option essentially sees you paying-off as much as you can on your property while working (reducing the loan-to-value ratio) and then funding your retirement by borrowing against the equity (the value of your home, less any mortgage) if and when you need it.

A number of strategies are available, including home reversion, reverse mortgage and home equity release.

Keep in mind that the amount of money you can access depends on your age, the value of your home and the type of equity release.

PROS OF LIVING OFF EQUITY

It's tax free:

You don't have to pay tax on this 'income stream' as it is effectively a loan.

You can tailor the amount of equity you borrow:

Whether it's regular payments, a lump sum, line of credit or a mix.

You don't have to sell:

If the equity is in your own home, you get to keep living there and you don't have to make repayments while you do.

Negative equity protection:

In other words, you will never end up owing your lender more than your home is worth if you take out a new reverse mortgage.

CONS OF LIVING OFF EQUITY

There are costs involved:

Application, service and end-of-agreement fees may apply. Check with your lender as they may vary from lender to lender.

A volatile market:

This strategy only works well if your property is increasing in value.

You are converting capital to debt, for yourself or your beneficiaries:

Some dub this investment strategy "spending wealth, rather than cash flow."

The amount you can 'borrow' is restricted:

If you're 60, you can only access 15-20% of the value of your home. As a guide, add 1% for each year over 60. Over time, your payback interest rates may be greater than an average home loan.

With home reversion, you 'sell' a share of your home usually for well under market value.



SELLING PROPERTY TO FUND RETIREMENT

To sell or not to sell? It's a question many Australian homeowners face as they enter retirement, regardless of whether it's the family home or an investment property.

If this is to be your major income through retirement, check that any profits you reap will equate to comfortable golden years.

Also consider the effects of re-buying or renting in the same market if you're downsizing.

PROS OF SELLING PROPERTY

Selling your property may mean you have an increased cash flow:

You can use it to pay off debt or invest in shares or in managed superannuation funds, which may provide additional tax benefits and liquidity.

You may not have to pay capital gains tax:

This may apply if your property is your primary residence, or you purchased it before September 1985.

CONS OF SELLING PROPERTY

Capital gains tax:

When selling an investment property you've never lived in, you may be liable for capital gains tax on any profit.

All the costs of selling a property:

Real estate agent fees, legal fees, moving costs and so on.

Timing:

If you need to sell in a hurry to fund your retirement, you may not be selling into the best market. Liquidating during a market downturn can mean a significant hit to your retirement income.

On the other hand, selling at the top of the market could mean boosting your super balance with a large lump sum, but remember the pension transfer balance cap limits the amount you can invest in a tax effective retirement pension.

Your bank balance:

Selling your home may impact the amount of Age Pension you receive.

No one-size-fits-all approach works when it comes to using property for retirement. With so many factors influencing your decisions, it's wise to consider your options and speak to your financial adviser.

Source: AMP



HOW DOES YOUR PENSION LIVE ON AFTER YOU DIE?

Account-based pensions offer a flexible and tax-effective method of drawing a regular income stream from superannuation.

They are an essential part of your overall retirement strategy and are usually used from retirement until death. But what happens to your tax-free account-based pension when you do die?

Superannuation does not automatically form part of your Will unless a Death Benefit Nomination is completed to that effect. In this article we examine the nomination of an individual beneficiary, where the nomination of a member's estate and a reversionary beneficiary nomination is not in place.

What are your beneficiary's options?

The short answer is it depends. To receive your account-based pension your nominated beneficiary may have two options:

1. Commencing a death benefit pension; or
2. Receiving a lump-sum payment.

Both options are subject to additional eligibility criteria. Let's briefly explore both options with our focus being option 1, commencing a death benefit pension.

Option 1: Commencing a death benefit pension

Features of a death benefit pension

A death benefit pension can basically be considered as allowing your account-based pension to live on after you die, for the benefit of your eligible beneficiary. Features of this pension are much the same as those for an account-based pension.

Arguably, the most attractive feature is the tax-free nature in which the assets will reside. Recipients are required to receive a minimum cash pension payment each year which is based on their age and pension balance as at the previous 30 June.

Death benefit pensions can also be rolled into another fund at any time, however, they retain their identity as a death benefit. Therefore, a death benefit pension cannot be combined with other pensions or rolled back to the accumulation phase.

Is your nominated beneficiary eligible?

Generally, only your spouse is eligible. Adult children and your legal personal representative (your estate) would have to receive the benefit as a lump-sum withdrawal, i.e., the assets are removed from the superannuation environment and subject to tax on the taxable component.

A dependent child (or children) may also receive a death benefit pension in limited circumstances; if they are under age 18; under age 25 and financially dependent on you; or have a prescribed disability.

Transfer Balance Cap

Another important matter to consider is your eligible beneficiary's Transfer Balance Cap (TBC).

To reiterate, the TBC is a lifetime limit on the total amount of funds that can enter the tax-free pension phase, currently at \$1.7 million. Where your beneficiary has already commenced an account-based pension and does not have a sufficient remaining TBC to receive the death benefit pension, they may roll back their existing account-based pension into the accumulation phase to create room for the death benefit pension.

Option 2: Receiving a lump-sum payment

The alternative is to receive the amount as a lump-sum payment. With this option, the funds exit the superannuation environment. The benefits may be cashed as either in-specie or cash depending on your fund's governing rules.

Conclusion

The death benefit pension option presents an opportunity for your eligible beneficiary to maximise the total amount of funds held within superannuation.

While there are limitations on who can exercise this option and matters complicated by TBC, it is still worth considering as the assets will reside in a concessional tax environment.

Source: Bell Potter