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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. Do you value your assets more than yourself?
1. Constructing a retirement portfolio in a low return world
2. What is Equity and how can I use it to Invest?
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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DO YOU VALUE YOUR ASSETS MORE THAN YOURSELF?

Value is a funny thing. One person's trash can be another person's treasure, as the old saying goes.

The value we place on something tends to be very individual, and is generally a product of many different factors ranging from cultural background and upbringing to personality type and even life stage.

But as much as the way we view value varies from person to person, there are also some common views that tend to draw us together. According to research commissioned by TAL, Australians are seven times more likely to name their possessions as their most valuable asset, rather than themselves.

The research revealed almost all Australians find it difficult to understand their own value. As a result, we tend to base our self-valuation on the amount we earn and own, while neglecting the intangible things such as the value of the social and emotional contributions we make to the lives of our loved ones.

The things we value will change over the course of our lives

Unsurprisingly, the research showed that throughout every generation, the things we place value on will change as we move through different life stages.

For those in their 20s and 30s, building a rewarding and successful career tends to be a strong focus, whereas those approaching or enjoying retirement tend to be more focused on staying healthy and supporting loved ones with practical tasks.

But where it gets interesting is when we look at how Australians felt their changing views on value over time had impacted the decisions they made along the way.

The long-term impact of our views on value

According to the research, the majority (78%) of Australians undervalue themselves and their contributions to others which over time has led to some regrets, including poor life decisions relating to their long-term wellbeing, as well as actions around protecting what they value.

The common views on value that draw us together

Despite our views on value changing as we move through different life stages, the research also found there are key areas of our lives which we are each underestimating when it comes to understanding our personal value, and this can subsequently have an impact on the choices we make.

In fact, Australians tend to fall into one of four different personal value profile types, which will influence the things they value and choices they make across their lives:

Gregarious Go-Getters (24% of Australians) – these people generally strive to have a successful career and are more likely to undervalue the importance of taking care of their health.

Conscientious Carers (28% of Australians) – these people highly value the emotional support they give to their loved ones but may question the decisions they make in life and sometimes wish they did things differently.

Family-Focused Optimists (32% of Australians) – these people tend to take a family orientated approach to life. They take care of their health but place less importance on their career than other areas of their lives.

Ambitious Organisers (16% of Australians) – these people are more likely to sacrifice their long-term happiness to focus on a successful career and tend to underestimate the value of their emotional support and time to loved ones.

So why does the way we view value matter?

With the research showing that many Australians believe underestimating their own value has led to some regrettable life decisions, it's important to consider how your present choices may impact you in the future and the things you will come to value over time.

After all, you are your most valuable asset – in every hour of every day, month and year of your life, especially to your loved ones.

Source: TAL

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 probability 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

WHAT IS EQUITY AND HOW CAN I USE IT TO INVEST?

Whether you're looking to invest in property, renovate or pay off something big, borrowing against the equity in your home may be helpful, if you're across the risks.

The equity in your property can be a valuable resource, as it may allow you to borrow money to achieve your goals, whether they be investment or lifestyle oriented.

If it's something you've been thinking about, here are some pointers to understanding what equity is and how it can be used, with the most important being, if you borrow against your property and can't make the repayments, you could lose your home in the process.

WHAT IS EQUITY AND HOW IS IT CALCULATED?

Home equity refers to the current market value of your home (which won't necessarily be the price you purchased it for), minus the amount of money still owing on your home loan.

To give you an example, say your home is valued at $800,000 and you still owe $300,000 on it, you'll have $500,000 of equity.

Keep in mind that as the market value of your property can go up or down, so too can the equity you have in it rise and fall.

To find out how much equity you have currently, you can organise a property valuation through various banks, lenders and independent agents.

Also note, even if you do have equity in your home, you won't always be able to borrow against it. Your lender will look at additional factors, such as your age, income, debt levels, the property's location and whether you have any children. This is because all of these factors could affect how much you can afford in repayments.

With that in mind, if you do have equity, you'll want to find out how much of it is 'usable'.

WHAT DO PEOPLE USE HOME EQUITY FOR?

The equity in your home can be used to secure finance for a variety of things, whether it's a home extension, renovations, investment property, shares, new car or various other big-ticket items.

When you use your home equity, you're effectively increasing the amount you owe to your lender and using your home as security for your borrowing.

With that in mind, it's a good idea to think about the long-term impact of taking on more debt.

Investing your money wisely could help you to increase your income, while borrowing money to pay for holidays or things that depreciate in value will come with greater risk.

HOW CAN I GROW MY HOME EQUITY?

Add value to your property

You can add to the value of your property by renovating, extending or even just making some small adjustments to improve your home's street appeal. The key here, however, is to avoid overcapitalising, which is when the cost of the work completed outweighs the value added to your home in the process.

See if the property has appreciated in value

If your property is in a high-growth area or you've owned it for a number of years, the property may appreciate in value over time without you doing anything. However, depending on changes in the property market, the reverse could also happen. With that in mind, it may be worth keeping up to date with market trends to see how your property is faring.

Reduce your home loan

Another way to increase the equity in your home is by reducing the size of your home loan, which you can do in a number of ways.

For instance, you could pay more than your minimum repayments (if you're in a position to) or refinance with a different lender if they can give you a better deal that's going to cost you less.

WHAT SHOULD I CONSIDER FIRST?

Before you use your home equity to take on an additional loan, or increase the one you have currently, there are questions worth asking:

- What do you want to use your home equity for and is it a good investment decision?

- How much will your repayments increase by and will you still be able to live comfortably?
- Will you need to extend the term of your loan?
- Have you accounted for a possible rise in interest rates?
- What happens if your property depreciates in value and your loan is worth more than your property?
- Do you have a household budget in place to accommodate for additional or unexpected costs?
- Can you access the equity in your property via your current lender, or will you need to refinance?
- If you do swap lenders, have you thought about break costs and application costs, including establishment, legal and valuation fees, stamp duty, and when lender's mortgage insurance may apply?

Accessing the equity in your home could be a smart move in helping you to achieve your goals.

However, it's important to stick to a workable budget, add in a buffer for emergency situations and be committed to making your repayments on time.

Remember, with any debt you take on there will be risks and using your home equity means you could lose your home if you don't meet your repayment plan.

If you would like some assistance, please contact your adviser.

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