

# your money your future

FINANCIAL PLANNING NEWSLETTER WINTER 2007

## Have you sought end of Financial Year advice?

Welcome to the winter edition of the HPH Hotline for 2007.

With the 30th of June deadline fast approaching, there's still time to seek end of financial year planning advice in conjunction with your Accountant and HPH.

From 1st of July, many of the recent budget changes will take effect, namely the changes to income tax thresholds, the removal of taxation on superannuation withdrawals for over 60's and in September, changes to Centrelink asset testing.

For further information on any of the above or newsletter content, please contact our office.

Cheers Rob, Adam and the HPH Team.

## Many happy tax returns

**Even if it's not your birthday, getting the maximum benefit from your tax return can be the perfect present.**

As the end of financial year approaches, consult your financial adviser about financial strategies that may reduce your tax liability. Here are just five ideas your adviser might consider:

- 1 Personal super contributions – if you're self-employed or receive less than 10 per cent of your income from employment, you may receive a tax deduction for personal super contributions
- 2 Government co-contribution – by making additional personal super contributions, those earning less than \$58,000 per annum may receive a

Federal Government co-contribution of up to \$1,500

- 3 Minimising capital gains tax – realising capital losses may offset capital gains, reducing your overall tax liability; capital losses from previous years may also be used, if appropriate for your situation
- 4 Protecting your income – the premium for income insurance that protects you against illness or accident may also give you a tax deduction
- 5 Gearing your investments – using 'other people's money' (by borrowing funds from a financial institution) can magnify your investment gains (and losses); importantly, the interest payable on investment loans can be deducted from your taxable income.



### The HPH Hotline Newsletter

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## Turbo charge (or torpedo) your investments

Everyone differs when it comes to developing strategies to obtain maximum gains from their investments. One concept you may have heard about is gearing.

The first thing to understand about gearing is that there are different types and names for gearing, including leverage. While there are subtle differences between the types and labels, the general concept remains consistent.

Before any discussion of gearing can take place, it is important to understand risk and its relationship to investment returns.

### 'The higher the return, the greater the risk'

It's an old financial saying, and it still holds true. If an investment strategy contains the prospect of enhanced or greater returns, then by definition it will generally carry more associated risk.

The entwined concepts of risk and return are important because it is the potential for greater investment gains that generally entices investors to consider gearing. But it is equally important – especially if you're new to the concept – to consider the possibility that gearing has the potential to both increase (turbo charge) and decrease (torpedo) your investment returns.

### So, what is gearing?

In a nutshell, gearing is the use of borrowed funds to supplement your own investment money. It is a term used for both property and shares, although it is perhaps most easily understood by thinking about an investment property.

Many Australians choose to invest in property. Typically, they use their savings to build a healthy deposit and then purchase a residential or commercial property with the assistance of funds borrowed from a financial institution.

The stake in the property represented by the investor's original deposit is known as owner's equity. Investors will make repayments against the borrowed funds over time – often using rental income from tenants – and, depending on the loan they have, may eventually own the property outright. If the investor wholly owns the property it is no longer geared.

### A simple example

Tim has saved \$80,000 and wishes to purchase a share portfolio. If he purchased shares that subsequently returned 10 per cent over the course of one year, his investment would increase to \$88,000.

Non-geared example	
Tim's original investment	\$80,000
Final investment value	\$88,000
Investment gain	10% or \$8,000

However, if Tim decided to use his \$80,000 as a deposit to take out an additional \$80,000 margin loan the situation would be substantially different. Firstly, Tim would need to agree to the share portfolio being used as a type of surety for the loan. Then, assuming a similar 10 per cent return on the portfolio over one year, his original investment returns would be significantly magnified.

You should note that this example does not take into consideration the interest payments, fees or charges that would ordinarily result from taking out a margin loan. Nonetheless, it highlights the enhanced gains investors can make by accessing borrowed funds through gearing in favourable market conditions.

Remember, however, that gearing can also magnify losses just as easily as it does profits.

### Types of gearing

Financial advisers are always investigating strategies that may provide an investment or tax windfall for their clients. A number

of different types of gearing are possible, including, but not limited to:

- **Negative gearing** – when an investment is purchased with the assistance of borrowed funds and where the rental or distribution income from shares (after the deduction of expenses) is less than the interest commitment for a particular year. This scenario typically results in an income tax deduction for the investor.
- **Positive gearing** – this is the corresponding situation where rental or distribution income is greater than the annual interest commitment on the borrowed funds. This is designed to produce immediate income gains for an investor, although it will not result in any income tax benefits.
- **Neutral gearing** – this is when rental or distribution income is equal to the interest commitment on borrowed funds.

### The lure of larger profits

Your suitability to gear investments will depend on your own individual financial circumstances. Among the many things you will need to consider are:

- your personal risk tolerance, in particular your ability to cope with potentially magnified losses as well as greater gains
- the suitability of the asset you are seeking to gear
- your investment timeframe
- the amount of money you are wanting to invest, and
- your profit (and loss) expectations.

For more information on how gearing might turbo charge your investment portfolio, speak with your financial adviser.

Geared example using a margin loan	
Tim's original investment	\$80,000
Tim's margin loan	\$80,000
Total investment	\$160,000
Investment gain	10%
Final investment value	\$176,000
(minus margin loan)	(\$80,000)
Tim's final investment value	\$96,000
Gain on original investment	20% or \$16,000

## International investments still offer prospect of solid gains

**International investments may not have looked like such a wise portfolio choice earlier this year, when sharp falls in global share markets in late February and early March sent shock waves through the investment community.**

Despite falls of around 6 per cent in the US, 8 per cent in Europe, 9 per cent in Japan and China, and 16 per cent in India, expert commentators did not believe this signalled the start of an extended decline, or 'bear' market, for international investments.

Rather, the general consensus was that markets had gone longer than normal since their last fall and were due for a sharp but short-lived 'correction'. In the short term at least, this has proved to be right. Investors who quit the market were again the losers. Over the few weeks post these falls, most markets quickly recovered any losses and moved on to post further gains.

Looking back over the past three or four years reveals an unusual phase of synchronised global growth – it's the first time in more than 30 years that no major world economy has been in recession.

And it's generally anticipated that while growth may moderate a little, this favourable environment may persist for some time, with the International Monetary Fund predicting a global growth rate of around 4.5 per cent in 2007.

Powerful economic expansion looks set to continue in rapidly industrialising countries such as China and India. The recycling of trade surpluses from developing and oil-exporting economies into the capital markets of the developed world, particularly the US, is also a factor supporting the prediction of continued global growth.

So while international shares may still experience some volatility this year, there are a number of factors leading to a forecast of solid gains during 2007 from diversified international investment portfolios selected by expert managers.

### **International economic growth forecasts**

US economic growth is forecast to moderate to its slowest pace since 2002 as a slowing housing market weighs on consumer spending, the main contributor to domestic economic growth. However, strong employment and wage growth are expected to assist the economy.

The US central bank has progressively brought interest rates up from 1 per cent to 5.25 per cent presently. It seems likely that US rates will fall later in the year as the economy slows.

Europe seems likely to avoid the impact of any US slowdown, although activity is expected to decelerate. European economic growth remains robust, with unemployment hitting a five-year low.

Japan's economic growth predictions moved from optimistic to cautious in 2006, but Japanese corporates are benefiting from solid profit growth and historically low debt levels.

It's important to recognise that the main drivers of global economic growth are emerging, rapidly industrialising markets, such as those in China and India. The major developed markets are all currently growing below the world average. Production from emerging economies is meeting demand from consumers in developed markets.

While some commentators question the sustainability of this environment, it's expected that any slowdown in demand may be largely offset by a growing consumer class in the emerging economies.

### **Global interest rates still historically low**

During 2006 short-term interest rates rose in all major economies, but despite these rises, rates remain low by historical standards, reflecting moderate inflation expectations.

### **International shares forecast to provide solid gains**

While there may continue to be some short-term turbulence in global share markets throughout 2007, current conditions indicate that we may expect

to see international shares provide good returns for the remainder of the year. Market valuations are reasonable and profit growth remains strong.

### **Impact of global warming**

It is not yet possible to tell how major worldwide environmental issues such as global warming will impact investment markets in the short term, or the extent to which risks are already being considered in market prices.

Over the medium term, however, companies that manage the risk to their business associated with their environmental footprint, and those that address climate change strategically, are perhaps likely to develop sustainable advantages which will benefit shareholders.

### **Portfolio diversification**

The Australian share market has provided excellent returns over recent years, and looks set to continue to attract strong investor support. At the same time, the rise in international stock markets has been less spectacular, and many markets now provide opportunities to diversify into a wide range of quality companies, often valued more cheaply than equivalent Australian stocks.

International markets also offer enhanced opportunities for specialist investment styles. The 'value' approach to investing has produced very strong returns for astute managers. The 'growth' approach to investing has fallen out of favour in recent years, leading to some very high quality 'growth' stock being undervalued relative to the broader market.

For more information about the outlook for international investments, speak to your financial adviser.



## A testing time for assets – making the most of upcoming social security changes to the assets test

There has recently been much talk about the importance of 1 July 2007 as a milestone date for superannuation – if you haven't heard, this is when many of the Government's 'simpler' superannuation changes are due to kick in.

But there is another date shortly after which heralds the start of two specific social security changes – 20 September 2007. As a result of the rules coming into effect, there is a short-term window of opportunity to enhance social security payments.

### 20 September 2007 – what's changing?

The changes to social security arrangements coming into effect on 20 September are:

- 1 A reduction in the pension assets test taper rate from \$3 per fortnight to \$1.50 per fortnight for every \$1,000 of assets above the lower assets test threshold.
- 2 The abolition of the assets test exemption for complying income streams purchased on or after 20 September 2007.

### Change 1: halving the assets test taper rate

Essentially, your eligibility to receive income support from the Federal Government depends on two factors: your income and the amount of assets you own. The changes coming into effect impact the assets test.

Currently, recipients of most social security pensions, including the Age pension and Disability Support pension, have their payments reduced by \$3 per fortnight for every \$1,000 of assets above the asset test thresholds. This is known as the assets test taper rate.

#### Asset test thresholds

	Single	Couple
Homeowner	\$161,500	\$229,000
Non-homeowner	\$278,500	\$346,000

From 20 September 2007, the assets test taper will be halved. This means that recipients of most social security pensions will have their payments reduced by \$1.50 per fortnight for every \$1,000 of assets above the assets test thresholds.

The new asset level at which social security benefit payments cut out under the new rules is shown in the following table.

#### New asset cut-out threshold (from 20 September 2007)

	Single	Couple
Homeowner	\$515,500	\$818,000
Non-homeowner	\$632,500	\$935,000

As a result of these changes, assets-tested pension clients receiving a part-pension may automatically receive a higher rate of pension from 20 September 2007. In addition, some people who do not currently qualify for any payment due to the assets test may be able to receive a pension after 20 September 2007.

To find out whether these changes allow you to qualify for a benefit or whether you can now receive an enhanced benefit, speak to your financial adviser. Alternatively, you may contact Centrelink or the Department of Veterans' Affairs to determine your eligibility.

### Change 2: complying income streams lose exempt status

As part of its 'simplified superannuation' package, the Government also announced the removal of the 50 per cent assets test

exemption for complying income streams purchased on or after 20 September 2007.

Currently, a complying income stream is one that meets certain legislated standards. These include lifetime annuities, term allocated pensions (TAPs) and certain term annuities that meet the prescribed standards. It should be noted, however, that an allocated pension or annuity is not a complying income stream.

Prior to 20 September 2004, complying income streams were 100 per cent exempt from the assets test. Complying income streams commenced after this date but before 20 September 2007 receive a 50 per cent assets test exemption.

Importantly, if you have previously purchased a complying income stream, the assets test exemption that applied at the time of the purchase will remain for the life of the pension. Right now there is a short-term window in which people can acquire a complying income stream and still access the benefits of the 50 per cent assets test exemption.

### Case study: John & Jenny

Both John and Jenny are fully retired and currently receive an Age pension. Along with owning their home, they have other assets totalling \$438,000.

Currently, the combined fortnightly Age pension amount they receive is \$255.80, based on the assets test. This amount is calculated using the current assets test taper rate of \$3 per fortnight for every \$1,000 above the relevant threshold.

The value of John and Jenny's total assets exceeds the assets test threshold by \$209,000. This means they currently lose \$627 per fortnight in their social security payment.

Assuming the value of their assets remains unchanged after 20 September 2007, thanks to the change to the assets test taper rate, their pension payment will increase to \$569.30 per fortnight.

In addition to this benefit, Jenny and John have consulted with their financial adviser about potentially purchasing

a complying income stream before 20 September 2007. This would allow them to boost their Government pension further by taking advantage of the 50 per cent assets test exemption that currently applies to complying income streams.

Their financial adviser steps both John and Jenny through the numbers carefully. He explains that if both of them separately purchase an \$80,000 complying income stream then they will be able to boost their combined pension payment by an additional \$120, bringing it to a total of \$689.30 per fortnight.

#### Note:

The rate of Age pension payment is calculated under both the income and assets test. The test that results in the lower rate is the one that applies. For the purpose of this case study, it has been assumed that John and Jenny's income is below the income test threshold of \$228 per fortnight.