Newsletter September 2014

Welcome to the latest edition of our client newsletter!

Our articles cover a range of topics which we hope you will find interesting. We aim to keep you informed of changes as they happen, but we also want to provide ideas to help you live the life you want – now and in the future.

Reflecting on the importance of financial security, now might be a good time to speak with those close to you about the importance of being financially literate – no matter what stage of life they're at. Transferring your knowledge and ideas can really help improve the financial literacy of those you care about.

If you have any questions or enquiries about any of the articles in our newsletter, or any other financial planning topic, don't hesitate to contact us.

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The search for alpha

Investment experts often talk about alpha and beta, but what do these terms mean?

While it may sound like Greek to you, and it is, it's not as complicated as you might think. Beta is simply what any particular market or index does – it's the benchmark. And alpha is the measure of how a managed fund can outperform the index.

In essence, if you are seeking alpha, then your aim is to get better returns than the market average. The way to achieve this is by choosing an actively managed fund over a passive (index) fund.

The management fees are lower for index funds than for active funds as they merely match a particular benchmark. That means they buy and sell less frequently, which reduces transaction costs. But there are still fees, so you will never fully receive 100 per cent of the returns from the market.

Those who support index funds over active funds argue that the market is efficient and therefore, over time, an active fund is unlikely to beat the benchmark.

Top funds outperform

If your actively managed fund performs in the top third of all funds, then the chances are it is beating the benchmark and more than compensating for higher fees.

The SPIVA Australia Scorecard, conducted by S&P on the performance of actively managed Australian mutual funds versus their benchmarks, found that in a one year period 68 per cent of active funds outperformed the ASX200 index. While, this figure reduced to 37 per cent over a three-year period and 30 per cent over a five-year period, it still means that if your fund performs at the top end then you are ahead[i].

Much of the performance of a fund comes down to the skills of the fund manager. With close to 400 managed funds investing in general Australian equities alone[ii], local investors are spoiled for choice.

(In)efficient markets

Another important factor in the active versus index debate is the efficiency of the respective markets. The theory goes that the less efficient the market, the greater the potential for a skilled investor to make a profit.

If you are looking at smaller listed companies, for instance, the market for these stocks is significantly less efficient than the ASX200 which is made up of the top 200 stocks. That's because fewer analysts research small companies and therefore investors are less informed. And that provides an opportunity for specialist fund managers who are prepared to do the research.

According to the SPIVA figures, the majority of active Australian small cap funds outperformed the ASX Small Ordinaries index consistently. In 2013, only 5.4 per cent of active managers failed to meet the benchmark[iii].

Growth vs value

Investors need to be aware that not all active funds are the same. Some active fund managers favour growth stocks while others favour value stocks.

Growth fund managers believe in the future potential of stocks to grow their earnings and hence their share price. So they would tend to choose companies in growth or developing industries.

Value fund managers, meanwhile, focus on out-of-favour stocks that appear to be under-priced by the market.

Given that the greater your diversification the wider you spread your risk, it can be argued that you should have exposure not only to both growth and value managers but maybe also to index funds.

Working out what is the best investment mix for you takes knowledge and experience. Make a time to speak with your financial adviser in regards to what works best for your individual risk profile.

i. http://us.spindices.com/search/?query=asx&Search=GO&Search=GO Click on SPIVA Australia Year End 2013 and go to page 6 for table.

ii. http://us.spindices.com/search/?query=asx&Search=GO&Search=GO Click on SPIVA Australia Year End 2013 and go to page 6 for table.

iii. http://us.spindices.com/search/?query=asx&Search=GO&Search=GO Click on SPIVA Australia Year End 2013 and go to summary.

Plan ahead for super pension changes

Changes to the deeming rules could make it more difficult in future to qualify for the age pension and the Commonwealth Seniors Health Card.

That's because tax-free income from account-based super pensions will soon be included in the income test for Centrelink purposes and to the Commonwealth Seniors Health Card income test. This will put income from super pensions on a level footing with income earned on investments outside super.

The good news is that you have until January 1, 2015 to prepare. Even then, if you are already in receipt of a pension, the new rules will only affect retirees with super pensions started on or after that date.

How does deeming work?

To be eligible for a full or part age pension you need to pass both an assets test and an income test. Under the income test, your financial assets are 'deemed' to have earned a set amount of income, regardless of how much they actually earn.

The current deeming rates for a single retiree are 2 per cent for the first $48,000 of a pension account balance and 3.5 per cent for the remainder. For couples the threshold amount is $79,600.

The new rules will have the greatest impact on retirees with more modest super balances, where the income test is used to determine how much age pension they receive. That is, single home-owners with assets of less than $135,850 or couples with less than $238,200[ii].

From 20 September 2017, the deeming thresholds for means-tested payments are set to be lowered to $30,000 income for singles and $50,000 for couples[iii]. This will make it even harder to qualify for a full or part pension under the income test.

A card with benefits

If you do not receive any Age pension, you may still be entitled to the Commonwealth Seniors Health Card. It provides access to benefits including pharmaceutical discounts and certain travel concessions.

There is no asset test to qualify for the health card but there is an income test, currently $50,000 for singles and $80,000 for couples[iv]. Currently, tax-free income streams from super pensions are not included in the income test but that will change on January 1.

Who is affected?

The new rules ensure that anyone who already has a super pension in place and either receives the Age pension (or other specified Government income support payment) or the Commonwealth Seniors Health Card will not be affected. That is, they will continue to be assessed under the current rules.

If you turn 65 on or after that date you will be assessed under the new rules. Similarly, if you are already in receipt of a pension (or other specified Government income support payment), but commence your super pension on or after 1 January, you will be assessed under the new rules.

Avoiding breaches

While existing pension and card entitlements will continue as normal come January 1, they could still be jeopardised if you breach the new rules.

For example, if a super pension is stopped and re-started, the new pension will be assessed under the less generous deeming rate system. This could happen if you fail to pay the minimum pension amount for the year or if you put extra money into your pension, technically re-starting it in the process.

Your estate plan may also need reviewing. For example, you may need to take steps before January 1 to ensure your partner continues to receive a part pension or the health card after your death. This is what is called a 'reversionary' pension because it 'reverts' to your beneficiary upon your death.

In light of these changes, if you still have money in an accumulation fund you might consider moving it into a pension.

There's still time to plan, speak to your financial adviser to discuss your retirement income strategy.

i. Australian Government, Dept of Human Services, http://www.humanservices.gov.au/customer/enablers/deeming

ii. 'Guide to keeping your old benefits' by John Wasiliev, Australian Financial Review 21-22 June 2014, page 26.

iii. 'Planning for the pension changes' by Bruce Brammell, Eureka Report 19 May 2014

iv. As above

To sell or not to sell?

For many Australians, the family home is their largest asset. And if you're planning to wind down from work, you may be considering what you'll do with yours.

Like many people, you may have worked for a lifetime to build the value you hold in your family home. While selling your home may not be your first choice, if your super balance is low this may be one way to release funds to help pay for your retirement. Or the idea of selling may be liberating—you may be ready to move and keen for a new adventure.

Either way there are financial, practical and emotional factors to consider first. Many people who sell up and move expect to have more money left than they end up with.

Things to consider

If you're thinking of moving to release money from your home, planning ahead can help you feel more in control and provide greater peace of mind.

Consider:

1. Making a wish-list before looking for a new place. Buying the right home means you're less likely to need to move again. Think hard about what features you need in your new home and what you can live without, as the more proceeds you have leftover can help fund your retirement.
2. The best location for now and the future. Remember you may need to access services and community support down the track so you may not want something which is too isolated.
3. Selling your existing home before buying another, although this may not be necessary if you can afford to hold two properties. Make sure you consider any potential capital gains tax implications if you own more than one property. While you don't have to pay capital gains tax on the sale of your primary residence, this is not the case for an investment property and you can't have more than one primary residence.
4. The costs of moving. For example stamp duty, real estate agent fees and property styling.
5. The impact of selling your home on any pension entitlements you may have.
6. Renting or house-sitting before buying in an area that's new to you.
7. Investing conservatively while you are house hunting so you give yourself some flexibility as you learn more about the choices and trade-offs involved in choosing the right property.

It's never too late to explore your options. And if time is on your side then planning ahead can help you to:

- uncover the opportunities available to you
- consider keeping your home and perhaps using it to generate income
- tidying up your key asset before selling so you can maximise its value
- manage your money from the sale—your home may be exempt from the assets test but a rise in your bank balance could reduce pension entitlements
- explore new locations that you may not have considered in the past

Regardless of your timing, it's always a good idea to speak with your financial adviser about the options for uncovering value in your home and creating a better retirement.