STRATEGIC PROSPERITY GROUP
FINANCIAL PLANNING SPECIALISTS

November 2014

Welcome to our newsletter.

The United States has put a spring in its currency's step with the pronouncement that six years of economic stimulus, designed to help the country recover from the Global Financial Crisis and involving more than US$4 trillion in asset purchases, is at an end.

The latest round of so-called Quantitative Easing began in September 2012 with a monthly injection of US$85 billion into the country's moribund economy. Since then the monthly purchases of US Treasury bonds and mortgage-backed securities has been tapered back to US$15 billion a month. The move doused investor speculation that the US economy was not strong enough to cope without the added stimulus. However, the Fed reassured investors that short-term interest rates would remain low for a "considerable time" as the country's economy gradually improves.

The greenback's strong gains in response to the news sliced nearly 1¢ off the Aussie dollar, which tumbled to US87.78 ¢. The Australian currency has fallen more than US10 ¢ in recent months as the US economy strengthens, raising expectations of an increase in local interest rates.

Global sharemarket reaction to the US tapering was muted. Protracted economic weakness in Europe and Japan will force their respective central banks to expand their own economic stimulus programs, keeping bond yields and interest rates low for the time being. However, the prospect of higher US rates could destabilise the Australian sharemarket, which is under pressure from weakness in the bank sector.

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BEGINNER'S GUIDE TO BONDS

When interest rates are low, people who depend on income from their investments are constantly on the lookout for ways to spice up their investment returns without veering into risky territory. If that sounds like you, it may be worth considering bonds. They might sound as sexy as cardigans and slippers, but bonds are gaining popularity among everyday investors for their ability to weather financial storms.

Bond returns are not stratospheric but they can be reliable and deliver regular income into your account. What's more, the forces that drive shares down are usually the same that prop up bonds, making them a handy way to diversify your investment portfolio.

What are bonds?

Bonds are a type of debt – a type of glorified term deposit. Companies and governments borrow money from you, the lender, and make regular interest payments, called a coupon, for the life of the bond.

There are many types of bonds, such as fixed rate, floating rate, inflation-linked and hybrids. They can be issued over three, five or 10 years and some as long as 30 years.

Bellwether bonds

Bonds are an excellent bellwether for the global economy. Their popularity tends to increase when economic times are tough and interest rates are low as they are now.

It may sound counter-intuitive, but the price of bonds rise when interest rates go down. Conversely, an interest rate hike can cut the value of your bond investments. The price movement depends on the size of the interest rate change and how long the bond has to run before it matures.

Fix, floating and inflation-linked

Bond interest rates are either fixed or floating. The interest on fixed rate bonds remains the same over the life of the bond. Floating rates change depending on market rates and inflation-linked bonds are tied to the rate of inflation.

Despite most economists predicting a rise in long-term interest rates, which would mean a fall in bond prices, incorporating a variety of bonds in your investment portfolio remains a solid strategy for protecting your cash flow from interest rate fluctuations.

Government bonds

Australian government bonds are regarded as risk-free and are used as the benchmark to measure risk in other asset classes. They are an ideal defensive asset and offer reliable returns.

Federal and state governments issue government and semi-government bonds respectively for medium to long-term investors.

Corporate bonds

Companies issue corporate bonds and other types of fixed-interest securities. Investors need to be mindful of a company's credit rating and where the bond resides in the debt hierarchy should a company collapse.

Despite offering better returns than their government counterparts, corporate bonds are also higher risk.

Hybrids

Hybrid securities are bonds with extra pizzazz. Like bonds, they pay a fixed or floating interest rate until a set date. Yet part of their appeal is the potential to convert them into the issuing company's shares.

Hybrids offer investors higher interest rates and the potential for higher capital gains (and losses) than government bonds. In terms of the trade-off between risk and return, they are closer to shares than bonds.

Buying bonds

Bonds can be bought upon issue and held until maturity or they can be bought and sold on the secondary market, offering the opportunity to make capital gains (or losses). Some are listed on the Australian Stock Exchange while others are traded via a broker.

However, the minimum purchase amount can be high when buying bonds direct. Professionally-managed bond funds are generally an easier way for private investors to expand their bond holdings.

The choice of bonds available to individual investors has grown enormously since the global financial crisis with access opening up to government bond, index, actively-managed and diversified bond funds. However, the complexity of the bond market means professional advice is recommended in order to select the right mix of bond investments for your future income needs.

If you would like to discuss bond investments within the context of your overall portfolio, don't hesitate to call.

TIME TO STEP UP SUPER CONTRIBUTIONS

Australians are going to have to save a bit harder to build their retirement nest egg, thanks to the recent government decision to postpone increases in compulsory superannuation. This and other changes make it more important than ever to take control of your retirement savings.

As part of the scrapping of the mining tax, the planned increase in the compulsory superannuation guarantee (SG) to 12 per cent has been delayed by six years. As a result, it is proposed that it will stay at 9.5 per cent until 2021 when it will increase by 0.5 per cent a year until reaching 12 per cent in 2025-26.

The other key change is that the $500 Low Income Super Contribution for workers earning less than $37,000 a year will be abolished in 2017.

The aim of this contribution was to create a more even playing field for low-income Australians. Because SG contributions are taxed at the concessional rate of 15 per cent, people on higher marginal income tax rates enjoy an advantage, whereas those on the lowest marginal rate of 19 per cent effectively receive no tax concession.

Additional contributions

As a general rule of thumb, it is suggested that you will need 70 per cent of your final annual income to enjoy a comfortable retirement.

While it has always been the case that anyone aspiring to more than a basic lifestyle in retirement needs to supplement employer contributions with their own savings, the delayed increase in SG payments underlines the importance of doing so.

The changes will leave some people tens of thousands of dollars worse off, but the actual amount depends on your age and financial circumstances.

Take the example of someone aged 20 earning $35,000 a year; assume they get a pay rise at age 30 to $80,000 (in today's dollars) and another at 40 to $150,000. Assume also that their salary is indexed by 3 per cent a year between pay rises.

Factoring in average returns of 7.35 per cent a year, our 20-year-old's balance at 65 would be $594,106 in today's dollars. Under the original SG timing, it would have been 2.65 per cent higher ($16,222) at $610,328.

But a 40-year-old who had salary sacrificed to build up $250,000 in super and was earning $180,000 indexed at 3 per cent would be 3.47 per cent, or $42,487, worse off at 65.

Low income super contribution

The removal of the $500 contribution will have the bigger impact for low income earners.

SGS Economics estimates that someone who earns $35,000 a year from age 22 to 69 will be 16.7 per cent worse off under the new rules. Only 3.9 per cent of that is due to the SG freeze; the remainder stems from the abolition of the rebate.

Boosting your super

There are several ways to maximise your retirement income.

- **Salary Sacrificing**

  One is through salary sacrificing up to your age-based limit. For those aged under 50, the cap is $30,000 a year including all SG contributions and $35,000 for those 49 or over at June 30 this year.

- **Non-concessional contributions**

  You can also make non-concessional (after-tax) contributions up to $180,000 a year, or $540,000 over a three-year rolling period.

- **Government co-contributions**

  If you earn less than $49,488, then you can benefit from a co-contribution from the government if you make an after-tax contribution to your super. This is worth as much as $500 depending on your actual income and the amount you contribute.

The changes may not make a huge difference to your retirement balance, but they do mean you will have to do more of the heavy lifting yourself.

If you would like to discuss ways to boost your retirement savings, please give us a call.

INFLATION and how to BEAT IT

The first place Australians turn to in the search for a safe haven for their savings is generally the bank. But safety can bring its own risks. When interest rates are low, the biggest risk to your future prosperity is inflation.

Inflation slowly nibbles away at the value of your money, so that $100 deposited today may not buy as much down the track as $100 buys today. That has implications for all of us who are saving for future spending such as a child's education or for retirement.

In order to preserve the value of your investments over time you need to earn a return equal to or above the level of inflation.

What is inflation?

Inflation refers to rises in price of goods and services. In Australia this is measured by the consumer price index (CPI).

Even though there are periods in history when prices fall, known as deflation, over the long term the cost of living inevitably rises. If you have ever heard your Grandad talking wistfully about the good old days when a meat pie cost sixpence (5 cents) – that is inflation at work.

At the moment inflation is running at an annual rate of about 3 per cent in Australia. That's not a concern for the economy or the Reserve Bank, which has an inflation target rate of 2-3 per cent. But inflation of 3 per cent is a concern for investors if it is higher than the "real" rate of return they are earning on their investments.

The "real" rate of return is the nominal or advertised interest rate minus inflation.

Real-ity check

According to ratings group Canstar, the best rate on offer for high interest savings accounts is currently about 4.0 per cent and only 2.5 per cent at the big four banks. That means investors who leave their savings in the bank are going backwards after taking inflation into account.

The story is not much better for term deposits. The going rate for a 3-year, $10,000 term deposit is about 3.6 per cent; slightly more if you shop around. A nominal return of 3.6 per cent provides a real return of just 0.6 per cent after inflation. Once you pay tax on the interest income, you are effectively losing money.

In order to protect your future purchasing power, you need to invest in assets with the potential to deliver higher returns than inflation in the long-run. That generally means investing in growth assets such as shares and property.

Growing wealth

Take the example of shares. In the year to June 30, 2014 the total return from Australian shares (capital growth plus dividends) was 17.6 per cent. After taking inflation into account, which was 2.7 per cent at the time, the real return was 14.9 per cent.

If you had all your savings in the bank during that period, you would have missed out on an excellent opportunity to grow your wealth. While share returns fluctuate from year to year, over the long term they beat cash, and inflation, hands down.

By way of illustration, an investment of $100 in the Australian share market in 1900 would have grown to $208,059 by 2008 in real terms. Cash would have grown to just $207 after inflation.[i]

Although there are brief periods when real returns from cash and bonds outdo other asset classes, in the long run shares and property are the real inflation-busters. With interest rates at historic lows, it is more important than ever to include growth assets as part of a well-diversified portfolio.

5 ways to beat inflation

- Shop around for the best interest rates on your bank accounts
- Pay attention to the inflation rate
- Focus on "real" returns after inflation
- Don't forget to factor in tax and fees
- Go for growth: shares and property beat cash in the long run.

i MLC, 'Why you need a return above inflation', http://www.mlc.com.au/mlc/im_considering_mlc/personal/education_and_calculators/education_and_strategies/investments/why_you_need_a_return_above_inflation