



# Personal Wealth



Autumn 2011

A Quarterly Newsletter for

**Lifespan Clients**

## Japanese Tsunami and Middle East Unsettle Markets

As we go to press a 9.0 magnitude earthquake has struck Japan and unleashed a seven-meter-high tsunami that has likely killed tens of thousands of people as it engulfed towns on the northern coast. Property damage is immense although the damaged areas of Japan accounted for less than 3 per cent of its GDP. Four nuclear reactors were damaged with 2 at risk of meltdown. One of the major economic impacts is expected to be ongoing shortages in electricity with risks to industrial production.

Previously the 1995 earthquake in Kobe Japan was the world's most expensive natural disaster and cost \$132 billion. It is too early to say whether the losses from this disaster will exceed that amount. In that case the Japanese stock market fell for 5 months before recovering. While the Japanese economy is going to take a short term hit, the rebuilding phase will generate increased economic activity in the future.

### Previous Quarter



The Australian ASX200 accumulation index rose 2.7% in the three months prior to 31 January 2011 with global shares (MSCI World Index) also rising 8.0% in local currency terms. This has been countered however with emerging market equities (MSCI Emerging Market Index) rising only 1.2%; effectively minus 0.2% when the rise in Australian dollar is taken into consideration. 10 year Australian Government bond yields rose from 5.3% to 5.6% while the dollar remains at parity with the US dollar.

Long term government bond yields also rose in the US along with stock prices which hit three year highs. While unemployment remains stubbornly high in the US, there is greater optimism that the economy has turned the corner. The

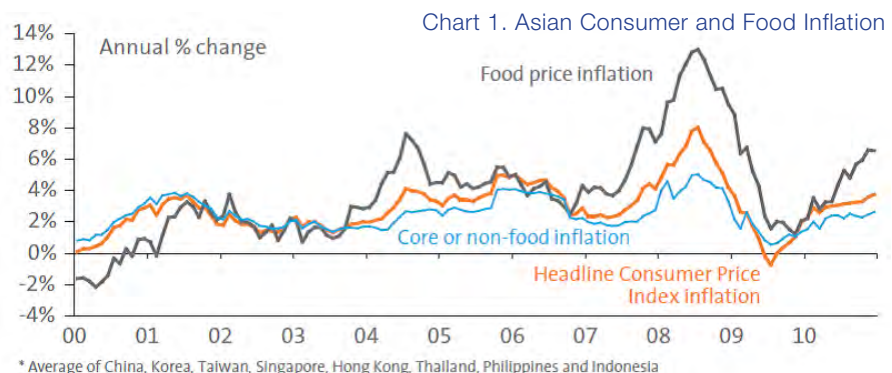
US economy was expanding at a rate of 3.2% in the 4th quarter of 2010. The devastation caused by the Queensland floods is expected to subtract at least 0.5% off GDP growth figures for the current year, and coupled with flat retail sales is most likely the reason the RBA has left interest rates unchanged.

### The Bigger Picture

Higher food and vegetable prices as a result of the Queensland floods will certainly raise inflation in the short term. However we expect the RBA will probably ignore the short term inflation rise and instead focus more on the hit to growth. We would still expect short term interest rates to rise later in the year.

Global equity markets have had a reversal in thinking, at least for the time being. The catalyst for this appears to be rising inflationary expectations in some emerging markets and a better macroeconomic outlook for developed economies. Due to the stronger growth in emerging market countries they have become susceptible to higher inflation, leading to rising interest rates as authorities try to cool down their economies. In particular this has been the case for two of the largest economies in the emerging market sector; India and China.

**Chart 1. shows some of the components of inflation in Asia.**



Source: Bloomberg, AMP Capital Investors

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One of the major contributors to inflation in emerging economies as compared to developed economies is food price inflation. In Asia, food comprises 31% of the basket used to calculate the CPI, and hence, inflation. This large percentage is because of the remarkably lower average incomes and disposable incomes of most workers and families in the region.

World food prices are currently at record levels due in large part to the unusual weather patterns we have seen around the globe, and could continue to rise if conditions don't settle. We would expect the Chinese and Indian equity markets to be subdued until we get to the end of the tightening cycle, possibly another 6 months or so.

One factor that has unsettled markets is the political demonstrations in countries such as Egypt and the fighting in Libya. The current uprisings in these oil rich nations have already led to rises in the price of oil. There is obviously concern around what systems will replace the current authoritarian regimes. One possibility, a radicalisation of the region, is very negative for oil prices and equity markets in general. Geo-political issues are also in play as Bahrain is the home of the US 5th fleet which is a major stabilizing influence in the region.

## Outlook and Markets

Earnings estimates for the Australian equity market are largely intact as a result of this reporting season. The Australian equity market has corrected about 6% from its February 17 high. The valuation of the Australian equity market (price earnings multiple or PE) is estimated at 11.8 times one year forward earnings estimates (UBS). The current PE remains about 15% below the long term average of 14.4 times (UBS),

and on this basis Australian equities still have some upside potential.

Developed market global equities are trading at roughly similar PEs to Australian stocks and are trading at an even larger discount to their long term average of over 15 times earnings. As such they represent good long term value.

Emerging market equities were trading at higher valuations than developed markets but have since corrected to be on similar PEs. Given the recent inflation concerns we have actually seen funds move away from emerging market equities. While we like emerging markets in the long term, sentiment has turned against them for the moment. There has also been a large variation in the performance of individual countries leading us to believe that most investors would be better off investing in diversified emerging market funds rather than single country funds right now.

The generally low level of global interest rates, we are not enthusiastic about global fixed interest as an asset class since the value of fixed interest securities fall when interest rates rise. Over the long term, bond yields should rise which will lead to lower prices. This does not necessarily mean that investors will lose money, just that returns will be low (as long as defaults stay low). We should note that the disaster in Japan has caused the Bank of Japan to pour \$183 billion into their financial markets. This is an attempt to increase liquidity and will tend to lower interest rates in the short term. This is analogous to the

quantitative easing in the USA. However given a choice we prefer Australian government bonds as yields have risen to roughly their long term average.

Given the volatility caused by the impact of the disasters in Japan and turmoil in Libya, cautious investors should probably wait for some stability and to see what direction markets take over the next few weeks. Our initial impression is that global markets will muddle through given valuations are quite attractive. In summary, we prefer equities to bonds. We also believe you should be looking to take advantage of the high level of the Australian dollar by directing a higher than normal percentage of your growth assets into unhedged global equities. On a ten year view, equities markets would appear to have the best investment potential compared to bonds and residential property which appears to be overvalued on some criteria. However prudent investors should diversify their portfolio across all major asset classes to minimize risks and smooth out future returns.



Chart 2. Investment Returns to January 31, 2011 (%)

Asset Class	1 month	3 month	1 year	3 years	5 years
Australian Shares	0.18	2.74	8.46	-1.26	3.64
Global Shares	5.36	5.76	6.26	-5.28	-3.68
Listed Property	2.41	1.53	5.01	-16.20	-8.85
Fixed Interest	0.92	0.73	5.59	7.33	5.92

Source: van Eyk



## Understanding the Rules of SMSF Borrowing

Borrowing within your SMSF to purchase property is a rapidly expanding area of the lending market. There are many rules which you should understand before venturing into borrowing to acquire property as part of an SMSF investment strategy.

- SMSF loans are a non-recourse loan to the fund and a Security Trust is established to 'hold' the property during the life of the loan. Non-recourse loans vary in several ways to a standard mortgage. Discuss the differences with your Financial Planner and a mortgage professional to ensure your SMSF will qualify to borrow before incurring the expenses of establishing a Security Trust.
- Once a loan has been settled to purchase a property the loan cannot be varied. Therefore any modifications to the property will need to be funded by the SMSF with no further gearing or increase to the loan to provide the extra funds required.
- Some lenders will allow you to refinance an existing SMSF loan from other institutions in order to secure a more competitive rate. This is more likely to be restricted to residential property at this stage.
- Funds which are going to be used as the deposit on a property must be held in the SMSF cash account. However, it is possible to arrange a pre-approval to borrow via your SMSF which will give you an assurance of finance approval before committing large amounts of cash to your SMSF which cannot be accessed until retirement.
- Existing properties within your SMSF cannot be used as a collateral security for another purchase within Super. Each new investment purchase will require a cash contribution to cover the deposit and Stamp Duty costs.

## Beware the following traps when considering SMSF borrowing

- **The Sole Purpose Test:** The sole purpose of a Super Fund is to provide benefits and income for members in retirement. Funds contributed to an SMSF cannot be accessed until the fund has moved to the retirement phase. If members require funds for business needs, or immediate family expenses the funds cannot be drawn from the SMSF cash account.

Unless you have satisfied a 'Condition of Release' the funds cannot be used for any personal purpose prior to retirement. If this occurs the ATO may deem the Super Fund to be non-compliant and the penalties are severe, including removal of trustees, large fines and taxing the Fund at the highest marginal tax rates.

If you are planning on committing cash to your SMSF in preparation for borrowing and investing in residential or commercial property, you must do so knowing the funds will be committed to your SMSF.

- **Maintaining Commercial Agreements:** If a SMSF is purchasing the business premises of the member it is important to maintain commercial terms in relation to the rental agreements.

If a business pays an artificially high rent to the SMSF, the ATO may deem this to be an attempt to get around the contribution rules. Similarly if the rent is set at an artificially low rate the ATO may deem this to be in breach of the Sole Purpose test.

- **Manage your Paperwork and Compliance:** There is a lot of compliance, reporting and paperwork involved in managing an SMSF. If you are not aware of the rules surrounding the compliance measures you should employ someone to manage this for you. You need to manage your compliance to the point of recording the minutes of each of your investment decisions. If the fund is audited and deemed to be non-compliant for any reason the penalties are severe. The compliance of the Fund in all areas needs to be understood, managed, and monitored regularly. Know the rules!
- **Changing SMSF Laws:** Changes to the rules for SMSF lending will require changes to the Trust Deed. If your investment strategy changes, or if the law changes then make sure you review your SMSF Trust Deeds to ensure they accurately reflect what your SMSF is trying to achieve.
- **The property market may have peaked:** Your loan to value ratio (LVR) for lending arrangements must be maintained. If there is a sudden decline in the property market, this could impact on the lender's view of your loan, and in extreme cases you may be required to make contributions to your SMSF to reduce the loan balance, and return the LVR to a compliant level.

Most lenders will also ask for Directors / Members Guarantees on the loan, so while the loan is a non-recourse arrangement to the other assets of the SMSF, the assets of the members which are owned outside Super could be captured or caveated by the lender in case of default.

- **Property Or Shares:** Is property the best option for you over the loan term? Shares may experience more volatility over a 10 year term, but may also provide greater long term gains. Discuss different investment options with your Financial Planner in detail before committing to an investment strategy.

This is only a summary of some of the main areas of SMSF borrowing. Talk to your Lifespan adviser for a more comprehensive discussion of areas which apply to your specific situation.



## Excess Super Contributions Tax Injustice

It is extremely important that you check very carefully with your adviser your levels of superannuation contribution from all sources. If you put too much into super, or in technical lingo, exceed your contribution caps, the Tax Office will impose very severe penalties – penalties which in our view and that of the majority of accountants, planners and superannuation professionals, are unjust and draconian.

The Tax Office has indicated that for the 2009/10 year 48,721 people will face penalty tax for exceeding the right super contribution. Approximately 35,000 people per year since the 2007 year have been affected. They will pay 46.5% penalty tax and in some cases 93%. The tax is calculated on the excess amount contributed not on the tax advantage obtained by the taxpayer by being taxed less within super.

A simple example will illustrate just how draconian and unfair this tax is. Suppose your marginal rate of tax is the highest 46.5% and you mistakenly contribute \$100,000 of non - deductible contributions into your super fund where you earn a tax free rate of 6% per annum. We assume it is tax free

because you are drawing a pension and pension funds pay no tax. Within the super fund you earn \$6,000 tax free. But the money really should have been outside super where you pay 46.5% tax which amounts to \$2690.

A fair penalty would be to take the \$2690 away from you and charge you a reasonable penalty of say 20% to 30% on top of the tax advantage obtained. This would be a maximum of \$3627 if a 30% penalty was applied to the tax advantage. However the minimum penalty in reality is \$46,500 which is out of all proportion to the actual tax benefit received over one year. The Tax Office catches up with excess contributions within a year or two.

This is a serious anomaly within the superannuation laws which the Tax Office has been very reluctant to rectify despite numerous representations made to the Treasury including our own. The number of press articles relating to this topic is increasing and we hope before long the government will see the light and amend the penalties.

## National Consumer Credit Protection Update

Quay Finance is the residential and commercial finance arm of Lifespan and is owned by the same shareholders as Lifespan. The Mortgage and Finance industry has recently commenced a period of greater regulation and transparency under the new National Consumer Credit Protection laws (NCCP) introduced by ASIC. The two main areas of the NCCP are (a) the disclosure of commissions and referral arrangements and (b) the selection of the most competitive and appropriate loan product for borrowers. These two things have

always been practised by Quay Finance. However, there are some changes to the way borrowers are introduced to Quay Finance for home and investment loan assistance.

At the time of the referral, all referrers including Lifespan Financial Planners are required to gain a borrower's consent to have their contact details released to a mortgage broker, as well as to disclose the potential commission that may be received. This is designed to ensure a borrower's decision to proceed and discuss their loans with Quay Finance can be made with a full understanding of the relationship between the referrer and Quay Finance.



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