your money your future

FINANCIAL PLANNING NEWSLETTER

Paying your bills in retirement

Retirees and those nearing retirement have learned the hard way the importance of holding a portion of their nest egg in low-risk fixed income investments. During the financial crisis cash and bonds not only outperformed shares and property, they helped investors protect their capital and pay the bills.[1]

Now that interest rates on most term deposits are below four percent[2] and the official cash rate is at record lows, the challenge is to find a decent yield without taking on too much risk.

The golden rule with all fixed interest investments is that the higher the interest rate, the higher the risk. While all investment involves some level of risk, it is important to understand your own risk tolerance so you can hold an investment portfolio that allows you to sleep at night.

Australian government bonds with their world-beating AAA credit rating are in a league of their own for investors with zero tolerance for any loss of capital.[3] The trade-off is the relatively low rates of interest paid on these investments. In recent months, the yield on 10-year government bonds has hovered just above four per cent.[4]

How bonds work

A bond is a security that pays a set rate of interest (the coupon) for given period of time (the term) and repays your initial investment at maturity. Unlike shares, which provide a share of ownership of a company, a bond is a loan from you the investor to the issuer of the security.

Returns from Australian government bonds are considered 'risk-free' and for this reason they are the benchmark against which all investment returns are measured. The same goes for term deposits and savings accounts which are government guaranteed for amounts up to $250,000.

While it is true that investors' capital is not at risk of loss if invested in Australian government bonds for their investment term, they are not totally risk free. The main risk is a rise in interest rates.

If interest rates rise, bond prices fall because investors can get a better yield on new issues. If rates fall then bond prices rise. This means it is possible to make a profit or a loss by selling bonds on the secondary market. However, if you hold your bond to maturity you receive your initial investment back in full. In other words, your capital is guaranteed.

State government bonds, or semi-government bonds as they are also known, generally offer slightly higher rates of interest in return for a little more risk.

Corporate bonds

Investors seeking higher yields than government bonds and term deposits, without the volatility of shares, traditionally look to corporate bonds. Yields of some bonds offered by well-known Australian companies reached seven per cent before Christmas.[5]

Continued next page

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Paying your bills in retirement continued

With corporate bonds, risk and returns are determined by the quality of the issuing company and where the bonds sit in the issuer's capital structure. The higher up the pecking order, the lower the risk (and return) and the more likely you are to get your money back if the company folds.

At the top of the pecking order is senior secured debt. These bonds tend to have fixed interest coupons and fixed maturities, for investors who value certainty and safety. Further down the pecking order sit unsecured and subordinated debt with more flexible terms and higher interest rates.

Lower again are hybrids which combine the characteristics of both bonds and shares. Products such as income securities, convertible notes and reset preference shares typically offer attractive yields and the potential for capital gains (or losses). Some can be converted into shares in the company that issued them.

Finally, at the bottom of the capital structure, sit company shareholders. If a company is wound up, shareholders are paid out after all bondholders.

Risk and returns

In recent years investors have been prepared to take on the additional risk of shares in return for a reliable income stream from blue chip Australian companies. But it is worth noting that the dividend income from shares is not fixed as it is with bonds. In fair weather, dividends tend to rise along with earnings but there is a risk that they may be cut if the company runs into turbulence.

The simplest way to invest in a diversified portfolio of government and corporate bonds and hybrids is via a managed fund. Regular income distributions include the coupons paid by the underlying bonds as well as capital gains. According to Morningstar, income returns from Australian bond funds have consistently outperformed term deposits over the past five years.[6]

By putting some of your money into a mix of fixed interest investments with staggered maturities you are in a better position to weather all stages of the investment cycle to help you pay your bills. If you would like to discuss your income strategy please speak to your financial adviser.

1 http://www.adbi.org/working-paper/2009/12/21/3424.dev.asian.local.currency.bond.markets/impact.of.the.global.financial.crisis/
2 Canstar, http://www.canstar.com.au/term-deposits/
3 http://www.tradingeconomics.com/australia/rating
4 Trading Economics, http://www.tradingeconomics.com/australia/government-bond-yield
5 FIIG, https://www.fiig.com.au/news-and-research/news-and-research/details/2013/12/13/yields-of-some-bonds-hit-the-magical-7
6 'The income advantage over term deposits' by Christine St Anne, 27 Nov 2013, Morningstar, http://www.morningstar.com.au/funds/article/income-advantage/6262

A digital life after death

The common thread shared among Walt Disney, Paris Hilton and Britney Spears goes well beyond entertainment.

They are all clients of a non-profit company that researches, advocates for and performs cryonics. That is, the preservation of humans in liquid nitrogen after death with hopes of restoring them to full health when new technology is developed in the future.

This is just one of the more recent examples in mankind's endless search for eternal life. But, in a roundabout manner, anyone with a laptop, smartphone and internet connection readily collects enough email addresses, passwords, hashtags, likes and PIN numbers to make it seem as if they're figuratively frozen in ice.

Everyone has a digital footprint

Consider for a moment your own virtual footprint. At a minimum, there's likely to be at least one or two social media accounts via Facebook or Twitter. Your bank accounts are almost certain to have online access, and perhaps there's also a few hundred dollars in a Neteller wallet for the odd flutter on eBay. That's before you even consider the personal data you have stored on the desktop at home, or on the iPad that never leaves your side.

These elements are an indelible part of our lives, but precious few of us consider the implications of these digital alter-egos as part of their formal estate planning.

Digital Wills and social media

Digital Wills are now being made available through respected organisations so people can ensure their online legacy lives – or fades – according to their wishes. The suggested check-list for those considering a digital Will includes:

- What are your digital assets? Make a detailed and accurate list.
- Who do you want to look after and deal with your digital assets after your death?
- Where are your digital assets, who can access them and what passwords or other access controls (such as encryption, etc.) are required?
- Which sites do you want to continue or close after your death? Are there any saved items you don't want deleted (such of photos or videos)?

The expertise of a Digital Will maker also helps friends and family negotiate the minefield of terms and conditions that the majority of us accept with a tick of a box. For example, some sites like Amazon do not provide any information on how to close the account of deceased users. iTunes is another grey area. No substantial law exists to say whether you really own the content forever, or just while you are alive.

These considerations are even more important for residents of Australia. While the right of publicity ceases when you die as a resident of most countries, no laws currently exist in Australia to grant a Will's executor automatic access to someone's social media accounts.

Storing your digital identity

In addition to Digital Wills, a popular alternative is to store important documents and passwords in an online vault. Businesses including SecureSafe and Legacy Lockbox offer secure online storage of passwords and documents. Password management accounts can also be set-up using software such as Norton Identity Safe while Google recently introduced a new program called Inactive Account Manager, which enables you to choose how you wish your Google data to be managed.

Perhaps these alternatives will be enough for the likes of Ms Hilton and Ms Spears to steer away from a trip to the liquid nitrogen tanks.

Australia's growing population. Get ready.

There are 5.2 million boomers in Australia born from 1946 to 1964. This compares with six million generation Xers born between 1965 and 1983. Generation Y, born across the 18 years to 2002, is expected to peak at about 7.4 million next decade.[1]

With Australia's population expected to swell by mid-century and the first wave of baby boomers reaching retirement, building up the nest egg has become more important than ever.[2]

Late boomers, generation X and Y have contributed to their superannuation fund for most of their working lives and are expected to be largely self-funded in retirement from the mid-2020s onwards. However, there is a large gap for the baby boomers retiring now between the superannuation they have and the amount they need for retirement. Either generation X and Y will be forced to support them in the form of more taxes, or Australia will need to import more taxpayers to spread the load.[3]

Generational financial strategies

Each generation has its own financial challenges and strategies vary depending on the stage of life people face.

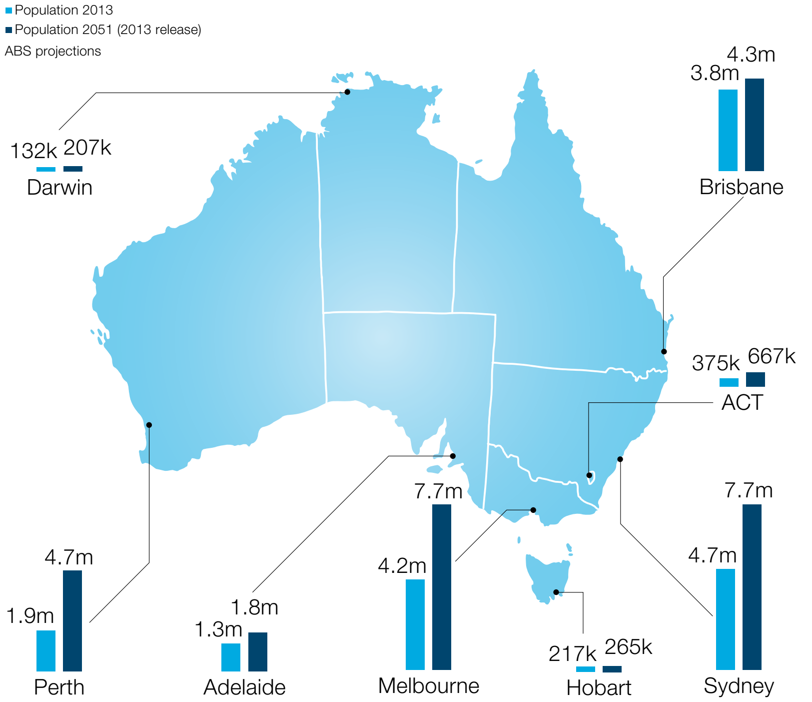
Age 25–35	With a higher disposable income and less family expenses, this is a good time to accumulate assets.
Aged 35–45	Paying down the mortgage and increasing home equity is the focus.
Age 45–55	Now is the time to shift focus to extra contributions to the retirement nest egg. Debt elimination remains a priority.
Age 55–65	Preservation of investment capital becomes more of a priority in addition to accumulation of capital. The last years of work should be devoted to topping up superannuation contributions.

Source: 'Super success achieved in stages;, 28 July, 2013, The Sydney Morning Herald, viewed 15 November <http://www.smh.com.au/money/saving/super-success-achieved-in-stages-20130727-2qrl9.html>

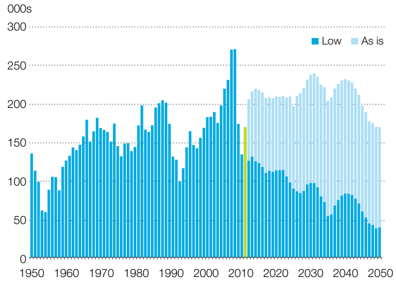
Market conditions

Whether the retirement age should be lifted to 70 along with compulsory superannuation being increased from 9.25% to 12% are among the policies being explored[4] to cope with a "big Australia". The Australian Bureau of Statistics recently projected the population would surge to 38 million by 2051.[5]

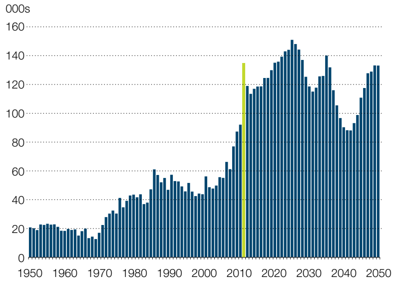
Pathways to a Big Australia



Propping up the worker base
Net growth in working-age (15-64) population



The Retirement Tsunami
Net growth in population aged 65+



Source: ABS; KPMG. Moment to find our bearings on the road to bigger things', 30 November, 2013, The Australian, viewed 15 November 2013 http://www.theaustralian.com.au/business/opinion/moment-to-find-our-bearings-on-the-road-to-bigger-things/story-e6frg9jx-1226771686987#

The future for Big Australia

A chart that featured in a November 30 article in The Australian by demographer Bernard Salt shows two possible pathways beyond 2012. One assumption puts net overseas migration at 140,000 a year and the other at 240,000 a year. The second chart shows the net addition to the retirement population averaged about 40,000 a year between 1950 and 2010. From 2010, more than 100,000 people annually joined the retirement ranks, with the number tipped to rise to 140,000 a year.

Salt argued net overseas migration of 242,000 people a year in the next 40 years could provide the skills and tax required to support the transition of baby boomers into retirement. Government spending across housing, health, infrastructure and pensions will have to increase further to accommodate greater boomer numbers.

Whatever stage you are at in your life, there is never a better time for you to plan your future. Speak to your adviser to see how they can help.

1 'We are at a population tipping point', 6 December, 2013, The Australian Financial Review, viewed 15 November, 2013 <http://www.afr.com/p/opinion/we_are_at_population_tipping_point_UgHzGKQHcuJs2ihM9QR9kl>

2 ibid

3 ibid

4 Commonwealth Government – Department of Treasury

5 http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/3222.0main+features52012%20%28base%29%20to%202101

Til death do us part

While a thorny issue at times, it's often worth having a discussion around inheritance.

Letting people know what is coming, or not, can avoid nasty surprises and expensive claims later down the track.

Estate planning is a fundamental part of financial planning, with the main aim being to plan for the distribution of assets in an effective manner after death. An estate plan will seek to ensure a person's assets are distributed in accordance with their wishes through a Will, superannuation nominations, life insurance and possibly testamentary trusts.

While a financial adviser can facilitate and oversee the estate planning process, it is a collaborative process involving a lawyer to establish a Will – a legal document which sets out how a deceased's assets and possessions are passed on. A tax accountant may also be required to advise on any tax consequences.

Have a little trust

In every family there could be a range of potential beneficiaries, some of whom may be too young to handle the proceeds of an estate. Other beneficiaries may be mentally impaired, or have a substance abuse or spending problem requiring careful oversight of how income or assets are passed to them.

A testamentary trust may be useful in such situations. A testamentary trust exists within a Will and comes into being upon death.[1] Instead of passing to a beneficiary, assets pass to a testamentary trust, administered by a trustee, for the beneficiary or beneficiaries.

For example, under a testamentary trust, the trustee could pay a regular income to a beneficiary rather than the beneficiary receiving all the funds in a lump sum.

Trusts are also used for asset protection. In the event a beneficiary got into financial difficulty, assets held within the trust ordinarily could not be reached by creditors.

Testamentary trusts are also useful should children get divorced and remarry. Assets held within a trust are generally excluded from property settlements.

Life insurance and superannuation

There are some assets which fall outside the Will, such as superannuation and life insurance.

Non superannuation life insurance benefits can be directed to nominated beneficiaries. The nomination is made directly with the insurance company and is generally paid to the beneficiary tax free.[2]

Superannuation can also be directed to beneficiaries outside of the Will. Where a superannuation fund allows, a binding nomination is made through the fund itself. In the event a binding nomination is not allowed the trustees of the fund decide who receives the money.[3]

Tax considerations

The tax office can end up doing quite well from inherited property and superannuation assets.[4]

With superannuation, the calculations around what tax may need to be paid by the beneficiary can be complicated and may require advice from a tax accountant.

The type of contributions made to the fund, including fully taxed (eg. employer contributions, salary sacrifice) and untaxed (eg. additional tax-free contributions), is also relevant. An adult, non-dependent beneficiary who receives super benefits could pay 0–30 per cent in tax depending on how the deceased made the contributions to the super fund.[5]

With property, care needs to be taken when beneficiaries inherit different assets. Consider one beneficiary inherits the family home, while another inherits the holiday house. The beneficiary getting the family home will generally not be liable to pay tax, while the beneficiary of the holiday house will probably have to pay capital gains tax when it is sold.

Tax issues may arise if a family home is transferred into a trust for asset protection purposes. The home may no longer qualify for the principal residence capital gains tax exemption and may be subject to stamp duty on transfer and ongoing land tax.[6]

Where a family home is passed on outside of a trust, the beneficiaries have two years to sell it before it becomes subject to capital gains tax.[7] Always seek tax advice from a qualified tax accountant in regard to all of these issues.

Estate planning can be extremely complex depending on an individual's circumstances. Financial advisers work collaboratively with other professionals such as lawyers and accountants to ensure a client's wishes are met. Having the family's blessing is a bonus.

1 https://www.moneysmart.gov.au/life-events-and-you/over-55s/wills-and-power-of-attorney

2 http://www.moneymanagement.com.au/professional-development/capability/insurance/onepath-matt-hughes-life-insurance-superannuation

3 http://www.findlaw.com.au/articles/1459/superannuation8230who-gets-it-when-you-die.aspx

4 http://www.superguide.com.au/smsfs/beware-the-dastardly-death-tax

5 http://www.superguide.com.au/smsfs/beware-the-dastardly-death-tax

6 http://www.yourinvestmentpropertymag.com.au/article/the-investors-guide-to-trusts-118760.aspx

7 http://www.ato.gov.au/General/Capital-gains-tax/In-detail/Guides/Guide-to-capital-gains-tax-2012-13/?page=94

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