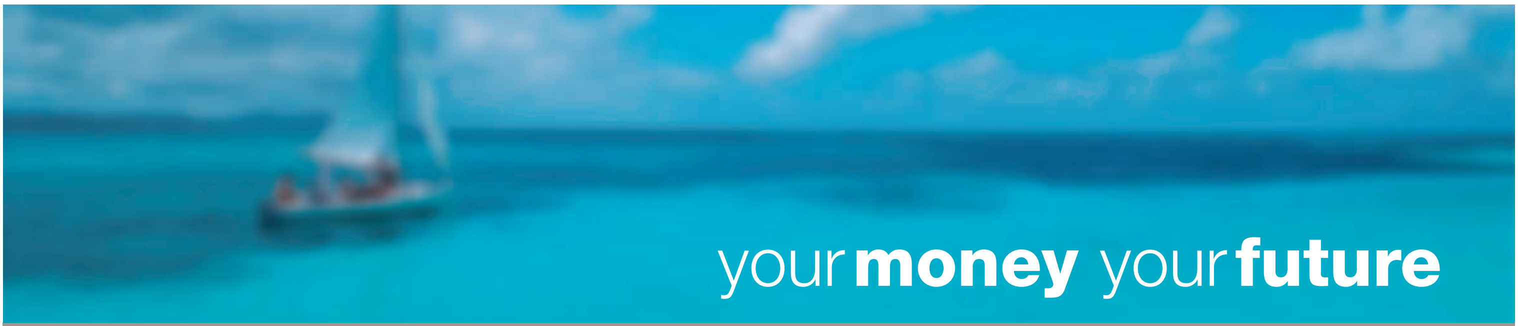

FINANCIAL PLANNING NEWSLETTER

Predicting Australia's economic future

If you took a snapshot of the Australian economy on New Year's Day 2011 it would show:

1 We are regarded as one of the stronger world economies, thanks to our recovery from the global financial crisis of 2008/09 (GFC) and continuing resource demands from China.

2 Exports of mineral resources make up 42 per cent of our export income, putting the mining states of Western Australia and Queensland at the centre of Australia's economy.[1]

3 Our dollar has increased in value against major currencies, putting our export industries under pressure, though the biggest of these, mining, is somewhat protected by rising mineral prices despite long-term contracts locked in US dollars.

If you took the same snapshot on New Year's Day 1901, Australia's birthday, it would have looked quite different. The newly federated Australia was emerging from the economic crisis of the 1890s; its major exports were agricultural commodities, mainly wool but with wheat and meat growing in volume; the gold boom which started in Victoria and New South Wales in the 1850s had passed but gold made up 28 per cent of our exports by value; and trade with China, and Asia generally, was irrelevant.[2]

Change is the constant

The Australian economy has evolved constantly over the past 110 years. In the 1930s, agriculture, once a third of our total economic output, began to shrink and now accounts for only 3 per cent. (Our farmers produce more today, but the value of their products has been overtaken by those of sectors like mining and services). Manufacturing then took over as our most important sector, reaching a peak of 25 per cent of economic output by the 1960s, then declining to less than half of that as manufacturing moved to cheaper labour sources in Asia.[3]

Today, the structure of the economy has changed once more, to the point where mining accounts for only 8 per cent of our economic output, but 42 per cent of our exports, against 14 per cent of exports for manufacturing and 23 per cent of exports for services (mainly education and tourism).

In practice, by and large we sustain our own economy today, consuming around 80 per cent ourselves of what we produce in goods and services. While our resources and other exported goods are important, they are not the main story at all; we are.

1 RBA

2 1901: A socio-economic profile of Australia at Federation, Parliamentary Library, Canberra. http://www.aph.gov.au/library/pubs/rn/2000-01/01rn23.htm

3 RBA

Continued next page

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Ensuring your future

There is little debate that income protection (IP) insurance is a valuable form of insurance for any working Australian.

How does IP work?

IP pays a monthly benefit, usually equal to a maximum of 75 per cent of gross income, if you are unable to work due to sickness, illness or injury. Your benefit payments commence after an agreed waiting period (usually 30, 60 or 90 days), and continue for the period specified in the policy (the benefit period), or until you return to paid employment.

Making it affordable

Many people who want to take up this type of insurance say that affordability is a barrier. If they then choose not to take it out, they are effectively choosing to 'self-insure', ie they hope they won't need it. However, the numbers are not reassuring. Each year approximately 1 million Australians experience serious injuries or illness that either require hospitalisation or prevent them from working, while approximately 117,000 Australians are 'permanently unable to work' due to illness or injury.[2] Sobering figures indeed.

One solution for working Australians is to take out IP insurance through their superannuation fund. The superannuation fund pays the premiums so day-to-day cash flow for the individual and the family is not compromised.

Matthew's story

A common question people ask when considering this strategy is, 'What's the effect on my long-term retirement savings in my super fund?' Each case will be different and must be assessed on its merits, but the following case study may provide you with some insights.

Matthew is a 35-year-old management consultant, a non-smoker in good health, and earning an annual salary of $100,000. He is considering 'level' IP premiums, ie the premiums do not increase with age but increase via cost of living adjustments or CPI. He has selected a waiting period of 30 days and wants benefits to be payable until he is age 65. He also wants the benefits paid to be the equivalent of 75 per cent of his salary, adjusted annually for inflation. With a mortgage and two young children, Matthew can't squeeze the insurance into an already stretched budget but he decides to pay for the insurance from his super fund.

Matthew reviewed four leading insurers, and calculated that the average level premium was $1,607 per year.

If Matthew does not make a claim over the next 30 years, $70,552 in premiums will be deducted from his superannuation. This dollar amount is not the full cost to Matthew as he forgoes the opportunity to earn a return on those funds each year. If his super fund earned an average of 7 per cent per annum, the foregone compounded return on those funds would have been $13,785 by the time Matthew turns 65. Taking out income protection through super in effect reduces Matthew's available retirement capital by $84,337.[1 3]

Cost versus benefit

The cost of not being able to work is real. If Matthew was unable to work for a period of time, what would be the impact on his retirement? There are two aspects to consider. There is the lost wage itself. But Matthew would still need to fund his living expenses so he would need to either access existing capital or borrow money to live, both of which are a cost to his retirement.

	IP insurance within super and no claim	IP insurance within super and cannot work	Self insure and cannot work
Matthew is unable to work for:	**At age 65, reduction in funds within super ($)**	**At age 65, reduction in funds within super plus 24% of lost salary and interest foregone or interest paid ($)**	**At age 65, total loss from salary and interest foregone or interest paid ($)**
1 year	84,337	119,040	148,602
2 years		153,970	298,176
4 years		224,640	600,796

The table above highlights the effect on Matthew's wealth at age 65 if he was unable to work for one year, two years or four years. It illustrates some of the dramatic financial (and personal) effects that occur in these situations.

Assuming the cost of money is 7 per cent, the total cost to Matthew by age 65 would be $148,602 if he didn't work for one year. There is $107,689 from his loss of income (adjusted for inflation), plus $40,913 from the compounded interest foregone on existing capital, or paid out on borrowings to replace the lost earnings. If Matthew had taken out IP insurance, his available funds at age 65 would be $64,265 higher.

A happy balance

In this case, the significant benefits of taking out IP insurance within superannuation are quite stark and should be considered seriously. Please contact our office if you would like to discuss this option further.

1 Assumes inflation of 2.5%. Assumes base premiums remain stable. Taxation is not taken into account under either scenario.

2 ABS

3 Assumes inflation of 2.5%. Assumes base premiums remain stable. Taxation is not taken into account in either scenario.

Predicting Australia's economic future continued

Australian economy: sectors by share of total, export value and employment

Sector	Share of output in the economy (% value)	Export value (% of total)	Employment (% of total)
Agriculture	3	18	3
Mining	8	42	7
Manufacturing	12	17	12
Services	77	23	78

Source: The Reserve Bank of Australia Bulletin, September Quarter 2010, Sectoral evolution in Australia.

But what does this mean for future Australians?

Our economic history suggests that mining may still be our most important export industry in 2050 or beyond, as we have always been a commodity-exporting economy. However, this is not guaranteed and the best way to cope with a constantly evolving economy is to make sure it is diversified across many sectors to manage risk across the cycles – just as a well managed, long term investment portfolio must be.

Not by mining alone

Mining may be the most important sector forexports today, but the services sector is the most important for jobs. However, mining and resources dominate most Australian media reporting so we may have a skewed picture of the total economy.

Let's take a closer look at the components of Australia's economy in the table below.

If Australian mining experienced a downturn tomorrow, our balance of payments would be under pressure, but we could still be in reasonable shape. A key reason for that is while mining is by far the biggest Australian export sector, it is highly mechanised and employs relatively few people.

Most Australians are employed in the services sector, which makes up 23 per cent of exports, but more than 60 per cent of local consumer spending and 78 per cent of jobs. Services cover virtually everything that isn't farming, mining or manufacturing: from IT, health care and education to lawyers, accountants, hairdressing and tourism.

So while the mining boom continues to help us earn export dollars and supports increased real incomes, it is the creation of more jobs in the services sector that keeps most of us employed.[4]

Though the worlds of 1901 and 2011 are quite different and our economy has undergone major changes in that time, one thing remains the same: per capita, we are still ranked among the richest countries in the world.[5] The lucky country indeed.

4 www.aph.gov.au/Senate/committee/economics_ctte/firb_09/report/c02.htm

5 World Bank

News bites

Australians third-richest in world

Australian adults are the third-richest in the world, ahead of countries like the United States and United Kingdom, according to a new study.

The Credit Suisse Research Institute's inaugural Global Wealth Report found that the average Australian adult's wealth had soared 211 per cent to US$321,000 in the past 10 years, as at mid-2010.

Switzerland and Norway emerged as the richest nations in terms of average wealth per adult, followed by Australia and Singapore respectively.

Interestingly, the report found the composition of Australian adults' wealth was heavily skewed towards real property, which forms 64 per cent of total household assets. As such the level of real assets per adult in Australia is now the second highest in the world after Norway.

The report also confirmed that Asia Pacific countries, which now make up the bulk of the world's middle class of emerging consumers, are driving the growth of the world's wealth. China is the third-largest wealth market in the world at US$16.5 trillion, 35 per cent greater than France, the wealthiest European country.

Back to school – don't miss out on the education tax refund

Getting the kids ready to go back to school can be an expensive time. But did you know the government provides up to $375 (primary) and $750 (secondary) per student as a tax refund for back-to-school expenses?

The Education Tax Refund provides up to 50 per cent back on a range of children's education expenses, such as school textbooks, stationery, computers, internet connections and educational software.

To claim the refund, keep the receipts of any education related purchases and use them to calculate your refund as part of your annual tax return.

Figures from the Australian Taxation Office (ATO) reveal that tens of thousands of eligible families did not lodged a claim last year, leaving $500 million in unclaimed benefits – so make sure you don't miss out in 2011.

Money can't buy you happiness

The British Government plans to introduce a new national happiness index to gauge its population's psychological wellbeing, according to British officials.

A similar initiative is already being investigated by Canada while French president Nicolas Sarkozy announced two years ago that he intended to use happiness levels to help assess the country's economic progress.

Data from several countries has shown that happiness levels remained more or less static, even though disposable income, financial security and GDP has risen substantially since the great post-war expansion of Western economies.

In contrast, in countries such as India, increases in material wealth actually have a positive effect on people's overall wellbeing.

So while money doesn't always buy happiness – especially in the West – being in control of your finances can help ease stress and promote overall wellbeing.

Rebalance – and tone up your investments

What is rebalancing?

Portfolio rebalancing is the process of bringing the different asset classes in your portfolio back into the shape set out in your financial plan. By rebalancing regularly – for example every 12 months or after a significant change in the market – you exercise essential financial disciplines by checking risk tolerance, time horizon and financial goals. And you keep your portfolio in good financial health.

Rebalancing is important because the different asset classes in your portfolio such as shares, bonds, cash or property, are not synchronised. Over any period, some will move more strongly than others, even within the same asset class. Within Australian shares, for example, the performance of mining shares could outstrip retail or bank shares.

But if your portfolio is increasing in value, why does any of this matter?

The reasons may not be obvious at first, but they are important. Because asset classes tend to rise and fall in cycles, a big increase in the value of your mining shares, for example, could leave you exposed and in a loss-making position if there was a fall in mineral prices and a drop in the value of those same shares just months later. In fact, the loss could wipe out a year or more of gains. (Think about the dotcom bust of 2000, for example, or compare Telstra's current price with what it was three years ago.)

The major purpose of rebalancing is to manage risk – to correct any over or under exposure to one or more asset classes. At the same time you are also sticking to the basic rules of disciplined investing, and this in turn is likely to boost the long-term performance of your portfolio.

Why do portfolios need regular rebalancing?

Consider the following case history. Alice invests $100,000 in a growth-oriented portfolio made up of Australian and international shares ($65,000), bonds ($30,000) and cash ($5,000). The share market has a great year, and 12 months later Alice's portfolio looks quite different: shares $81,600, bonds $31,150 and cash $5,250. Her portfolio has gone up by $18,000 and she is very happy indeed, as she should be.

At the same time, Alice's portfolio is now out of balance, leaving her more exposed than she wanted to be to the share market, with less of a buffer from the bonds and cash that provide stable returns. To rebalance, she has to sell some of her shares and reinvest the money in other asset classes to again reflect the original portfolio allocations of 65 per cent in shares, 30 per cent bonds and 5 per cent cash. She can either sell off some growth stocks and re-invest the proceeds in cash, or review the entire share portfolio and weed out underperformers – in practice, usually a combination of both.

Rebalancing for profit

The good news is that while she is bringing it back into balance, Alice's portfolio is getting stronger. She is locking in some profits when share prices have risen, and adding to her cash and bond holdings. She is putting into practice two important principles of successful investing:

1. Sell high, buy low. By selling off some of the top performers, you are taking your profit before that asset sector falls, and re-investing the profits in lower-priced asset sectors that have potential to become top performers in the future.
2. Discipline. By investing in a disciplined, balanced way, you resist the temptation to anticipate or guess which sector will come out on top next year. Figures show that taking that approach – chasing the market – usually ends in tears.

Positive money management

By rebalancing your portfolio you will experience fewer negative returns than if you left it alone, and when the market cycle changes you'll have more capital in higher performing asset classes to take advantage of the upswing.

If your money is invested in a multi-asset-class managed fund, your fund manager will almost certainly rebalance to stay aligned with the fund's investment objective. And if you manage your own superannuation fund or have direct shares or other investments, following a regular rebalancing cycle is a simple discipline but one you should take seriously.

However, remember that if you sell some of your shares you may bring forward tax liabilities, depending on your current and likely future tax rates.

Rebalancing may seem simple in theory, but it is good practice to seek the advice of a professional to assess the full implications – the strength and performance of your portfolio depend on it.

Sources

1 Chasing the market, P. 1, point 2: Historical Asset Class Performance: Major Market – Risk and Returns, 1987–2009 (AXA data)