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FINANCIALLY SPEAKING

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LONSDALE

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2008 A tale of two outlooks

Investors are increasingly uncertain about the market outlook for 2008. Some say higher oil prices and housing market weakness will drag the US economy into recession and take the global sharemarket down with it. Others think global sharemarkets will rally behind emerging economies strength. Matthew Sherwood, Perpetual's Senior Manager, Investment Markets Research discusses the 2008 outlook and why sharemarket returns should remain positive.

In 1859 Charles Dickens wrote the novel, 'A Tale of Two Cities' and the first sentence reads, 'It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness'. This statement is one of the most famous in English literature and is the precursor to us seeing how people respond differently to the same environment. Although the book is set during the French Revolution, investment markets over the past two centuries have demonstrated that Dickens' assessment of human behaviour is timeless and not limited to wartimes.

The global economy is moderating, but remains fundamentally robust

Between 2003 and mid-2007 the global economy experienced its strongest sustained period of growth since probably the 1920s. During this period growth exceeded 4% each year, reaching a 33-year high of 5.4% in 2006. However, at present it appears that the global economy has entered its potentially most difficult period since the 2001/02 recession and analysts have downgraded their 2008 growth outlook to 4.75% (from 5.2%).

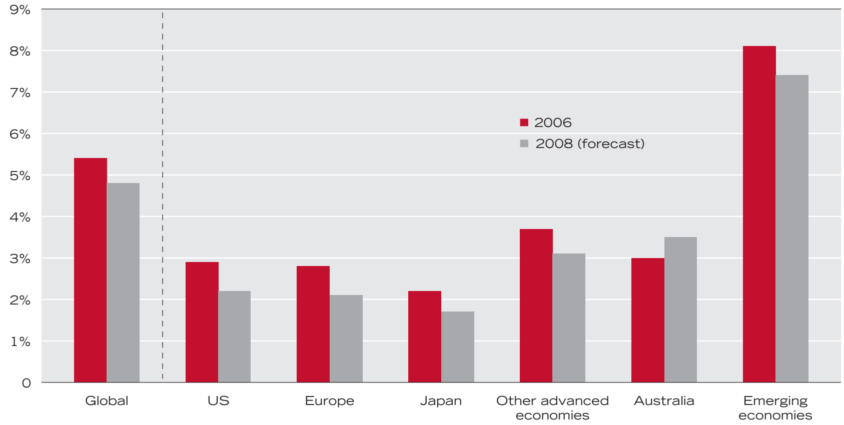
All major economic regions are slowing

In 2008, the global economy is facing some major headwinds. These include oil prices rising 41% since August to almost $100 per barrel, a worsening US housing downturn and the financial turmoil evident in August possibly having further to run. However, the impact of these factors on the global economy remains uncertain. Some say the global economy will follow the US into recession. Others believe the sustained strength of the emerging economies will underpin another strong year for global economic growth. All major advanced economies (other than Australia) are expected to experience slower growth in 2008 (see Graph 1). Nevertheless, the emerging economies now dominate global economic growth and their sustained and widespread industrialisation, urbanisation and infrastructure development should enable the global economy to grow above 4% for a sixth consecutive year in 2008.

2008 – A TALE OF TWO OUTLOOKS continued

GRAPH 1 – **Global economic growth is moderating**

Global economic growth: 2006 and 2008 (%)



SOURCE: INTERNATIONAL MONETARY FUND (SEPTEMBER 2007)

GRAPH 2 – **Global earnings growth appears set to moderate**

Global economic and earnings growth (%)

SOURCE: UBS LIMITED AND PERPETUAL INVESTMENTS AS AT 20 NOVEMBER 2007

GRAPH 3 – **Australian earnings growth should remain above average**

Australian Market Index of 12-month forward consensus EPS

SOURCE: UBS LIMITED AND MACQUARIE EQUITIES AS AT 10 NOVEMBER 2007

Earnings growth will drive shares higher in 2008

The key determinant of global sharemarket returns over the next year will be the impact of a lower US dollar, slower economic growth and higher energy prices on corporate earnings. Despite some claims to the contrary, corporate earnings growth has a strong correlation with the economic cycle (see Graph 2). If this historic relationship holds, slowing global economic growth in 2008 and 2009 (to around 4.75%) suggests that global profit growth will also decline from its recent highs, although it is unlikely to turn negative. Historically, earnings growth has only turned negative when global economic growth has declined to below 3% (see Graph 2) and the sustained strength of the emerging economies suggests this is unlikely to occur.

Risk needs to realign to a lower-return environment

US corporate profits are likely to moderate despite being supported by foreign-sourced income, which accounts for around 40% of total S&P 500 earnings. A weaker US dollar and robust non-US economic growth should provide support to US corporate profits. Growth in other regions is also expected to ease back, although there will be sporadic improvements as well.

On balance, the strong state of corporate balance sheets, 15-year low valuations and solid 2008 earnings growth should support returns, though not to the same extent as in previous years. This new environment should highlight two things to investors: firstly, global sharemarket returns are likely to moderate and secondly, portfolio risk should be examined to ensure it's aligned with a lower-return environment. Consequently, we would expect that stocks with low earnings risk, conservative debt levels, attractive valuations and solid dividend yields should find favour with investors.

The Australian economy is robust, but inflation is rising

Although interest rates have risen five times in the past 18 months, Australian economic growth is continuing to accelerate and the economy will soon enter its seventeenth consecutive year of growth. The domestic economy (excluding the drought ravaged farm sector) grew by 5.2% over the year to June 2007 (latest available) and subsequent data for employment growth, retail sales, credit growth and investment have indicated that this momentum has continued.

Change in Government should have little near-term impact

On 24 November, Australia voted for a change in Federal Government for the first time in 11 years and the new Prime Minister has identified five key areas of focus for his first 100 days in power; Ratify the Kyoto Protocol, begin negotiations for the staged withdrawal of combat troops from Iraq, start reform negotiations of hospital practices with the States, begin the rollout of the high-speed broadband network and upgrade trade training centres in secondary schools. None of these announcements should have any material impact on economic growth.

The Rudd Government is expected to spend some time initially looking for areas to cut current spending as a way of partially offsetting the vast amount of additional spending emanating from the implementation of its electoral announcements. These announcements should add around 0.75%-1% to the growth of an economy already accelerating at an unsustainable pace and such stimulus would be expected to further intensify demand side pressures.

The mining boom will also support growth in 2008

Looking ahead, the de-coupling of the Chinese economy from the US suggests that the income effect of the mining boom is set to continue. Robust growth in commodities demand, global supply constraints and the depreciation of the US dollar have contributed to expectations that iron ore and coal contract prices will rise further next year, which would support economic growth.

Earnings growth is easing and valuations are reasonable

Although the Australian sharemarket has risen by around 15% from its lows of August 2007, the rise has been driven by a small number of stocks in the resources, mining services, banking and retail sectors. While stocks have risen since August, the earnings outlook for 2008 has been subjected to downward pressures from several sources including the rising Australian dollar and higher labour costs. Accordingly, analysts have wound back their expectation for 2008 earnings growth from 13% to 8% (see Graph 3), with all sectors experiencing downgrades (with the exception of the banks). Importantly, the market sell-off in mid-November has removed some of the valuation froth and the Australian sharemarket is now closer to ‘fair value’.

Investors are banking on the banks

A renewed focus on earnings and valuations has positively impacted demand for banking stocks, given their strong earnings per share growth (relative to the remainder of the market), the continued strong demand for credit, the robust state of their balance sheets, high dividend yields and attractive valuations. The banks also have minimal revenue risk from offshore activity. Although around 20 large cap industrial stocks have material US$ and/or US economy exposure, none of them are banks and as such will not be negatively impacted by the rise in the Australian dollar.

At present, the market is focused on gearing, not valuations

Recently, stocks with low levels of debt on their balance sheet have outperformed their industry peers, irrespective of their current market valuation. Stocks like Woolworths, WorleyParsons, Cochlear and Leighton Holdings have experience solid price gains despite having above average P/E ratios. One could rightly question the sustainability of this trend over the medium-term.

Returns are set to moderate

With domestic interest rates rising and earnings growth slowing, investors appear to have re-focused on earnings certainty and seem to have shied away from companies with a high-risk outlook or high valuation. Although earnings growth has slowed, it nevertheless remains above its 20-year average of 6.2%, which should enable solid dividend growth over the next 12 months.

Implication for investors

As Dickens might say “investors need to be wise, not foolish” in this environment and ensure that portfolio risk is completely compensated. The elevated currency, higher domestic interest rates and slowing global economic growth suggest that the balance of risks at the stock level are tilted to the downside, that is, companies are more likely to disappoint earnings expectations than exceed them. Accordingly, companies with low gearing, high levels of earnings certainty, pricing power and a history of paying high dividends would be expected to perform well, with a well diversified portfolio helping any short-term slips in market sentiment.

SOURCE: PERPETUAL INVESTMENT MANAGEMENT LIMITED

The new "Better Super" System – it is better, and it is simpler

No one could ever pretend that Australia's retirement income system, including superannuation, is simple, however the changes that came into effect on 1 July 2007 have definitely made some improvements. Superannuation can now be more tax effective than ever before, and is simpler (but not simple!) for superannuation members to understand.

The major change that occurred relates to tax on the end benefit. Previously, your superannuation was broken down into as many as seven different components, each of which had its own tax treatment. You may recall seeing phrases in your annual member statement such as "post `83 component", "undeducted contributions", "pre '83 component".

A major part of retirement planning was understanding these components to allow for the best possible tax outcome.

All of these confusing tax components have now been abolished and replaced with two simple components: "tax-free" and "taxable" (NB: some people under 60 and receiving an income stream may notice that the old components still exist on their annual statement. Don't worry, they will be converted when you either turn 60 or make a lump sum withdrawal).

That's the simplification side of things (actually there's more, but we don't have time to go into it all, see below for suggestions on where to get more information), what about the improved tax efficiency?

The best news is that for anyone aged 60 and over, tax on superannuation has been completely abolished, even on the "taxable" component. No matter how much you take out of your super fund, or if you take it as a lump sum or pension, it remains absolutely tax-free.[1] You don't even have to include it in your tax return. Superannuation just got a whole lot more appealing.

How much can I put in?

If you are under 65, every three years you can contribute up to $450,000 of your personal, after-tax money to your super fund. These contributions are called "non-concessional".

If you have turned 65, but are under 75, you can contribute up to $150,000 per year in "non concessional" contributions based on the minimum work requirement of 40 hours in a 30 day consecutive period.

You and your employer can also contribute up to $50,000 per year (under 50s) of pre-tax dollars, $100,000 if you are 50 or over. This includes all Superannuation Guarantee and salary sacrifice contributions. If you are self-employed, this would include contributions for which you claim a tax deduction.

1 Benefits are tax-free for members aged 60+ whilst the member is alive. If the member dies, beneficiaries may be subject to tax on the inherited benefit. Members should speak to their financial planner about estate planning opportunities.

There were many important superannuation changes that came into effect on 1 July 2007, and others relating to social security benefits that came in on 20 September 2007 that may interest you. To get more information, you could contact your financial planner, your superannuation fund or go to www.ato.gov.au/super.

Are there going to be any more changes?

A new Government is always going to want to make their mark, so we do expect some tinkering around the edges. Labor has not, at this stage, made any major announcements.

In the election campaign Kevin Rudd announced that a Rudd Labor Government would help first home buyers save for a larger deposit using new, low tax superannuation-style savings accounts.

Rumours also abound of a possible increase in the Superannuation Guarantee, perhaps with an opt-out feature.

Time will tell, and we'll just have to wait until the May 2008 Federal Budget to see the extent of any further proposals. For more information about superannuation, speak with your financial planner.

SOURCE: CHALLENGER MANAGED INVESTMENTS LIMITED

Is your estate plan current?

It is the start of a new year and why not make time to address some of those important issues we tend to avoid. Estate planning is probably one area that is set aside for another year however estate plans drafted before the advent of the 'Simpler Super' system should be reviewed to ensure that the strategies are still valid and/or maximise the benefit under the new rules.

Under the 'Simpler Super' system introduced last July, lump sum death benefits from super no longer incur tax, regardless of the balance, provided the funds are paid to a death benefits dependant (as defined under tax law). A death benefits dependant is a spouse, former spouse, child under 18 or someone else in an interdependent/financially dependent relationship with the member at the time of his/her death.

Meanwhile, an income stream can now only be paid to a member's dependant as defined under super legislation. This includes a child who at the time of the member's death is:

- younger than 18,
- disabled and any age,
- 18 to 25 and financially dependant on the member.

Moreover, an income stream to a member's child (excluding a disabled child) is only payable until he/she turns 25 at which point any residual capital is paid as a tax-free lump sum.

Where an adult child has been included as a beneficiary in a binding death benefit nomination but he/she isn't eligible to receive an income stream under the new legislation, the fund rules will determine how the benefit is to be paid, either at the trustee's discretion or to the deceased's estate.

If your estate plan was drafted before the introduction of the Simpler Super system, it's important to revisit your strategies to ensure they're not only still viable under the new system but also make the most of new opportunities.

Two important estate planning considerations that need to be taken into account include how the proceeds will be taxed and, where applicable, whether the payment would be better taken as an income stream or lump sum.

For example, while super paid as a lump sum to a death benefit dependant is always tax-free, the ages of the member and beneficiary can affect the tax treatment of an income stream. If both the member and beneficiary are younger than 60, the inherited income stream will include a tax-free portion and a taxable component (see Table below). The income stream becomes tax-free once the beneficiary turns 60.

In turn, where the death benefit will be paid as a lump sum to a non-dependant, such as an adult child, various strategies can be used to minimise the tax payable on the amount, including a recontribution strategy which boosts the tax-free component of the individual's super balance.

It's important that you speak with your financial planner about what options are appropriate in your circumstances.

SOURCE: ZURICH AUSTRALIA LIMITED

TAXATION OF PENSION PAYMENTS DUE TO DEATH OF A MEMBER (TAXED SCHEME)

Taxation of pension payments due to death of a member (taxed scheme)	Age of beneficiary upon reversion of income stream	Taxation of income (taxed scheme)
60 or older	60 or older	Tax-free
60 or older	Under 60	Tax-free
Under 60	60 or older	Tax-free
Under 60	Under 60	Tax-free component is tax-free Taxable component is taxed at the beneficiary's marginal tax rate and receives 15% tax offset Taxable component becomes tax-free when beneficiary turns 60

Protection for a lifetime's worth of assets

HARD EARNED, WORTH PROTECTING

What are your assets? When you think of the term 'assets' you most likely visualise possessions such as your home and car, or perhaps you think of jewellery, savings or investments. As valuable as these are, assets can also include intangible objects that may not immediately be considered in dollar terms.

This article is aimed to help you determine the full scope of your assets, their worth, and how you can best protect them.

What are your most important assets?

Once you broaden the definition of asset, the priority previously given to tangible assets may change. An easy way to determine the importance of your assets is to classify them into three categories.

1. Relational Assets

These are assets based on the relationships you have with the people closest to you and are characterised by a high degree of emotional and physical dependence or interdependence, such as:

- your spouse and their contribution as a breadwinner or home manager
- your children and their future potential
- yourself and your contribution as a breadwinner or home manager
- other dependants, such as elderly parents, and
- children from a previous marriage.

2. Personal Assets

These are assets which have a quantifiable dollar value and which you identify as part of your personality, such as:

- your home
- your motor vehicle, and
- your household possessions and valuables.

3. Financial Assets

These are items which hold financial value but which generally have no personal or emotional value, such as:

- superannuation
- investment property, and
- shares, bonds and bank accounts.

What value do you place on these assets?

One of the great ironies of financial planning and decision making is that we spend most of our time thinking, planning and worrying about financial and personal assets, and our relational assets rarely come into consideration.

What about the 'volatility' of your assets?

A characteristic of all asset types is volatility. The most common concerns regarding asset volatility are in relation to financial assets. For example, a share portfolio is generally considered to be relatively volatile due to the ongoing possibility of gains and losses. These may amount to changes in value of 10, 20 or even 30% in a year.

However, the volatility of relational assets far exceeds this. 100% of a breadwinner or home manager's dollar value can be totally lost at any time, through major illness or injury.

What does this mean for you?

The high value and extreme potential for volatility of your relational assets makes them worthy of careful consideration. While the protection of these assets may not be something that you have considered in the past, a few minutes spent calculating their worth may be the most financially powerful thing you ever do! The following list provides a good starting point.

Protecting relational assets

- Breadwinner(s) – project income over the remainder of your working life, with some allowance for inflation.
- Home manager – calculate a dollar value for the duties undertaken by the home manager which would have to be paid for if you were no longer capable of performing these duties. This includes childcare, cleaning, transportation, cooking, home maintenance, accounting and laundry.
- Children's potential – for each child, calculate the funds required to allow completion of education and any additional amounts required for tertiary study and realisation of their full potential.
- Dependants – how much will it cost to provide home and medical assistance for dependent relatives who may require independent care so that a surviving spouse is not left solely responsible?
- Bequests – do you have any relatives, charities or children from previous marriages who you want to provide for? If so, how much will this amount to?

Protecting personal assets

- Home – how much debt remains on your home? Would you want this to be paid out?
- Car and other possessions – do you have personal loans and credit debts that would need to be paid?
- Future plans – are there any planned future purchases for major items such as a child's wedding that you want to provide for?

Protecting financial assets

You may have savings and investment goals that will be interrupted if you were to suffer from serious injury, illness or premature death. These may include large purchases such as a holiday home, boat or overseas vacation. Do you want to have to liquidate existing assets to provide an income stream, or even allow funds for these goals to be immediately realised by a surviving spouse or dependants?

Income Protection Insurance

There are a vast number of illnesses and injuries which have varying terms of impact. These often fall outside the scope of total and permanent disability and critical illness insurance. Income protection is designed to protect you from a loss of income due to such conditions by paying a replacement monthly income of up to 75% of gross income.

Critical Illness Insurance

Critical illness insurance provides a cash lump sum upon diagnosis of certain medical conditions. While these may not be conditions that cause permanent disability or an inability to work, they generally require significant lifestyle changes, can involve exorbitant medical fees and include conditions such as heart attack, stroke and cancer.

Total and Permanent Disability Insurance

This provides a lump sum if you suffer a major illness or injury which leaves you permanently incapacitated. The extent to which you must be incapacitated varies between insurance companies, but generally relates to a permanent inability to work. There are often also provisions to allow payment in the event of particularly serious injuries such as loss of sight.

TED AND JEMIMA'S STORY

While Ted and Jemima describe their lifestyle as comfortable, they don't consider themselves to be rich. They apply a monthly budget to their income and consider themselves to be financially responsible.

However, when they decided to visit a financial planner earlier this year they received quite a surprise.

Ted and Jemima's profile

- Ted is 42 and earns $75,000 pa as a leagues club manager
- Jemima is 40 and earns $35,000 pa working as a part-time sales consultant
- They have two children aged 5 and 7

Protecting their relational assets

Ted and Jemima determined that they would both prefer to continue working part time if either passed away, and so decided that they needed an insurance benefit to replace part of their income and to provide for a nanny.

- Their financial planner calculated that to replace 60% of Ted's income for the next 15 years (until the children finished school) would require capital of $675,000
- To replace 60% of Jemima's income would require $315,000
- Hiring a nanny to perform basic home duties would cost approximately $30,000 pa for the next 12 years and would amount to $360,000
- They also wanted to establish an education fund of $100,000 per child if either parent were to die

Protecting their personal assets

- Ted and Jemima would like to extinguish their $220,000 mortgage in the event of either dying
- They have personal loans and credit card debts of $15,000

Financial assets

- They are saving to buy a holiday house which they estimate would cost $150,000

Their protection program

Ted's total protection needs amount to $1,620,000 and Jemima's $1,260,000. Their financial planner recommended they insure these amounts against death and total and permanent disablement.

She also recommended that they should each have critical illness insurance to cover the cost of the mortgage plus one year's salary. This benefit would fund an extended period of leave without pay and provides a contingency fund for medical expenses, house renovations and rehabilitation.

Ted was also advised to insure his income for the maximum amount of $4,687 per month.

Creating your asset protection program

The value of your relational, personal and financial assets might be enormous, so what types of insurance can you put in place to create an 'asset protection' program? There are four main categories of insurance which are designed to work together to provide security for you and your loved ones.

PROTECTION FOR A LIFETIME'S WORTH OF ASSETS continued

Life Insurance

This benefit provides a cash lump sum in the event of death. This can be paid directly to a beneficiary for immediate use in whichever way they see fit – there are no restrictions on what the money can be used for. Some life insurance policies also provide for an early payment if a terminal illness is diagnosed.

The next step

While this article provides a useful introduction to asset protection, a full analysis of your personal situation requires expert attention. Your financial planner can show you:

- how to accurately calculate your protection needs
- how to build an integrated plan, combining the four types of protection, and
- how to source quality protection plans at an economical cost.

You don't have a choice about being exposed to these risks, but you do have a choice about protecting yourself and your loved ones against unforeseen financial exposure.

Did you know

- A study conducted by the Australian Bureau of Statistics measured the economic value of typical household tasks. They calculated that such tasks would amount to approximately $580 per week if performed by paid outside resources.[1]
- Males between the age of 30 and 65 have a one in five chance of dying before age 65 and a one in six chance of suffering a serious disability (of at least six months duration) before age 65. Females aged between 30 and 65 have a one in seven chance of dying and a one in four chance of suffering a serious disability.[2]
- A child's education journey might cost anywhere between $7,653 (without childcare) and $190,895 for a full time private education including a university degree.[3]

1 Australian Bureau of Statistics, Unpaid Work and the Australian Economy 1997, Canberra 2000.

2 Australian Institute of Health and Welfare

3 Carly Schwerdt, B. Vis Comm (Hon), B. Ed (Specialisation), Why save for Education?

Hints and tips

Deciding who owns an insurance policy is an important decision. The person nominated as the owner of a life insurance policy receives benefit payments directly, without the need for distribution through a will.

Check your employer superannuation policy to see if a death and disability benefit is provided. While this may not protect all of your needs, it should be taken into consideration when formulating your protection program.

Some policies provide a cost saving by allowing you to combine multiple benefits under the one policy.

Want more information?

Speak to your financial planner today to find out how you can protect your financial future.

SOURCE: TOWER AUSTRALIA LIMITED

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