Capstone FINANCIAL PLANNING

Informedinvestor

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Investing for children

One of the world's leading investors and philanthropist, Warren Buffet once said "A very rich person should leave his kids enough to do anything, but not enough to do nothing".

It's only natural that every parent, regardless of their financial position, wants the best for their children. So if you're in a position to invest money specifically for your children's future, you should consider your options carefully – just as you would if you were investing for yourself.

All too often people make the mistake of heading into investments without exactly defining what they're trying to achieve; so the first step is to clearly identify why you're investing. The next step is to set a measurable goal and then implement a strategy that will achieve your goal while keeping in mind your personal circumstances, appetite for risk and investment time frame.

So for example, if you're saving for your children's tertiary education, figure out how much a university degree may cost, how much you need to regularly save and what investments are appropriate given your time horizon.

Sounds simple enough right? The real challenge is in determining which investment option most benefits you and your children and, more importantly, the relevant tax implications. This is where a Financial Adviser can really help.

The taxman taketh away

There are steep tax penalties on children's investment earnings to discourage parents from hiding their income in their children's accounts in order to avoid paying tax on their earnings.

These penalties mean that, for the current financial year, children under 18 can only earn $416 tax free. Any income in excess of $417 (and below $1,307) is taxed at 66 per cent, while investment income above $1,307 is taxed at 45 per cent. These penalties mean that you should consider some more tax-effective options that you can take advantage of[1].

Investing for children can be a real minefield. Some of the more attractive investment options are complicated and are likely to be unfamiliar to you but the significant tax benefits make it well worth investigating further. Speak to us, your Financial Advisers, about the best option for you and your children.

Options for investing for children

Investment bonds

Income from investment bonds, or insurance bonds as they're sometimes known, is taxed at the corporate tax rate of 30 per cent rather than your marginal rate. The tax within the bond may also be further reduced as a result of franking credits and tax offsets, as well as other tax deductions from underlying investments. There's no need to include anything (income or capital gain) on your tax return if your funds remain invested for 10 years. If they're withdrawn before 10 years, tax rebates will apply, and after 10 years there's no tax liability whatsoever on withdrawals.

There is a 125 per cent rule though. In the second and subsequent years of the investment period, you cannot invest more than 125 per cent of the previous year's investment. If you do, you trigger a new 'start date' of the bond for tax purposes (the 10 year time frame begins again).

Education savings plans

Education savings plans encourage regular savings and, similar to investment bonds, are taxed at the corporate tax rate of 30 per cent instead of your marginal tax rate. Most also allow you to claim a full credit for taxes paid if the investment is used for educational purposes. However, unlike investment bonds, education savings plans do not have a 10 year or 125 per cent rule. Instead the maximum overall contribution for each student is $365,000. You also don't have to report earnings in your tax return while your investment remains in the savings plan. The catch is that these plans generally have high fees and may not allow you to withdraw your investment early, or if withdrawal is possible, it may trigger a penalty. So make sure you check the finer details.

Pay down the mortgage

If you have a mortgage with an offset account or redraw facility, you can 'save' for your children's future by making extra mortgage repayments. Then simply redraw the extra payments you previously made to pay for things like your children's education. This will reduce the principal owing on your home which will, in turn, reduce the interest that you pay. These additional payments cannot be taxed, as no 'earnings' have been made even though the interest you save is a close substitute for earnings you may have received from a different investment option. And this method of saving is generally pretty flexible as you have access to your funds when you need them. You need to be disciplined though. Don't go using your extra funds for other purposes like that holiday you 'had to have'. Also make sure you check any fees you may need to pay for the privilege of having an offset account or redraw facility.

There are many strategies you can consider when investing for children – speak to your Capstone Adviser for further details.

1. www.choice.com.au

Source: IOOF

Economic Highlights

- US – mixed signals as retail sales dipped and industrial production fell. But home prices and housing permit numbers rose.
- Europe – further concerns as weakness spread from southern EU to Germany where production (output) fell. Anxiety also fuelled by more downgrades of regional banks.
- Japan – caution prevails. Tokyo condo sales have dropped 15% over the year and industrial sector production fell by 3% over the month.
- China – further easing of monetary policy in the face of weakening spending and abating inflation.
- Australia – stronger than expected Q1 growth data and employment numbers. The AUD performed strongly over the month.
- Long-dated bond yields moved higher. Global equities were boosted by the summit in Europe. Most commodities gained ground over the month.

Australia

Economic news focused on national growth and labour force data. Gross domestic product (GDP) rose by 1.3% over the March quarter, more than double the market's expectation of 0.6%. Unsurprisingly, expanding productive capacity in the mining sector was evident, with non-dwelling construction (+12.6%) underpinned by a surge in engineering construction (+19.7%). Household consumption also posted a comparatively modest but still significant gain of +1.6%, defying anecdotal evidence of ongoing caution on the part of consumers. At the overall level, the year-on-year rate of growth (+4.3%). While still impressive, the result came of an exceptionally low base that included impacts of the 2011 Queensland floods and cyclones. From next quarter, these events will drop out of calculations.

The Australian labour market in May confounded expectations creating a total of 38,900 jobs. Moreover, the result was strong, with the addition of 46,100 full-time positions more than offsetting the loss of 7,200 part-time jobs. The employment gains prompted more people to look for work, pushing the participation rate to 65.5% from 65.2% previously. This nudged the unemployment rate up to 5.1%, after the previous month's result was revised to 5.0%.

United States

Disappointing retail sales data for May reignited concerns that the US economy is losing momentum. Sales declined by 0.2%, and there were downward revisions to the April (-0.2% from +0.1%) and March (+0.4% from +0.7%) results. However, a review of the major spending categories revealed the May result was largely driven by lower petrol (-2.2%) sales. Elsewhere, there were signs of consumer resilience. Specifically, increased spending on typically expensive items such as furniture (+0.4%), cars & parts (+0.8%) and electronics (+0.8%). Interestingly, non-store (+1.3%) sales growth exceeded 1% for a fourth consecutive month. This category encompasses online sales suggesting the weak headline result reflects shifting spending patterns.

Because consumer spending is an integral component of US economic activity, it is widely held that broader growth will remain tepid while consumer caution prevails. Home sales are an important indicator of consumers' sense of financial well-being, given the portion of their wealth tied up in a home. With this in mind, May's home sales report made for interesting reading. The year-on-year rate of change in the average home price accelerated to 6.4%, from 5.5% previously. The rebound is even more striking considering prices were depreciating until February (-0.3%) this year.

The rate of creation of new home stock eased in May, as housing starts declined by 4.8%. However, this followed an upward revision of 34,000 to the total of the previous two months' results. More significantly, year-on-year rate of change was 28.5% – this has accelerated steadily since the start of the year, when growth was slightly below 14%. Similarly, the corresponding measure of housing permits (+25.0%) remains well ahead of its growth rate of approximately 20% in January. Permits typically lead starts by several months, suggesting that there may be further gains in housing starts over the course of the northern summer.

Industrial sector production fell in May (-0.1%), however, it followed a solid rise in April (+1.0%). Manufacturing (-0.4%) dampened May's result, outweighing gains in mining (+0.9%) and utilities (+0.8%). The year-on-year rate of change (+4.7%) remains well above its January (+4.4%) reading and fractionally ahead of its average rate of growth over the previous four months (+4.6%). Capacity utilisation (79%) has also lifted slightly since January (78.7%).

Europe

Industrial production data for April underscored the extent of the slowdown in economic activity in Europe. For the second consecutive month, output fell within the core European nations, declining by 0.8%. A sector breakdown revealed weakness in capital (-2.6%), intermediate (-1.2%), durable consumer (-0.9%) and non-durable consumer (-1.6%) goods sectors. Lower capital goods output is a particular concern, as it typically represents input capacity for future production. At a country level, weakness has spread from southern nations, such as Portugal (-6.5%) and Italy (-1.96%), to the leading regional economy Germany (-2.0%). In year-on-year terms, regional production declined by 2.3%, well down from the (-1.6%) at the end of 2011. Moreover, it has fallen every month of 2012.

China

Monetary policy dominated economic news from China after the People's Bank of China (PBOC) lowered its benchmark one-year lending rate by 25bp to 6.31% and deposit rates to 3.25%. In addition, the PBOC relaxed lending control measures, allowing banks to increase their discretionary discount on the benchmark lending rate from 10% to 20%. Subsequent data showed continuing easing of consumer price pressure. The year-on-year measure of the Consumer Price Index fell to 3.0% in May, down from 3.4% previously and well below market expectations. This mirrored a fall in consumer spending, as the year-on-year rate of retail sales growth slowed to 13.8%, below expectations and April's gain of 14.1%. The factory sector showed signs of resilience with a rise in industrial production growth to 9.6% from 9.3%.

Japan

In Japan, data for May revealed continued caution on the part of consumers. Condominium sales in Tokyo dropped by 14.9% over the year, while department store sales declined by 1.0%. Signs of moderation appeared in the industrial sector, where production declined by 3.1% over the month. This was below market expectations and caused the annual rate of growth to ease back to 6.2%. By contrast, there was an improvement in the labour market, where the jobs-to-applicant ratio rose to 0.81, its highest level since August 2008. Reflecting these greater employment opportunities, the unemployment rate dropped to 4.4%, from 4.6% previously.

United Kingdom

Consumer restraint was similarly evident in the UK, where prices eased in May. The consumer price index declined by 0.1%, largely due to lower transport (-0.8%) and recreation (-0.4%) costs. These outweighed a solid increase in household (+0.6%) costs and a rebound in food (+0.3%) prices following two consecutive monthly falls. May's result extended a period of price moderation, which has seen the year-on-year rate of change fall to 2.8%, from 3.6% in January. An inflation rate below 3% is widely regarded by UK investors as one that warrants an easing of monetary policy.

Source: OnePath

Easing into retirement

More than ever before, Australians are now transitioning gradually into retirement, rather than abruptly ending full-time work. In fact, 48% of full-time workers aged 45 or over are planning to move to part-time work before retiring[1].

This can be driven by financial concerns or lifestyle goals, or a combination of the two. Many people like the flexibility of easing into the next phase of life after over 40 years in the workforce. The following case study shows how this can be achieved.

Robin's goals

Robin is one such person who wants to wind back her working hours gradually. At 59, she's keen to spend time with her first grandchild, but isn't quite ready to retire just yet as she'd like to maintain the social interaction and mental stimulation she gets from work. With this in mind, she decides to cut back to three days (24 hours) a week.

She meets with her Financial Planner to make sure she can maintain her current lifestyle, while structuring her salary in the most tax-effective way possible.

Work part-time without reducing income

After scaling back her working hours, Robin's salary drops from $100,000 to $60,000. Her Adviser suggests setting up a Transition to Retirement Pension (TRP) as the income from this will replace her pay cut of $40,000. This means she can maintain her after-tax income.

A TRP is a special type of income stream available for people aged 55 and over that lets you access your super benefits before you retire[2].

By implementing a TRP, Robin can now:

- invest some of her super in the TRP, and
- use the regular payments from the TRP to replace the income she misses out on when moving to part-time work.

She can also:

- reduce her hours without reducing her income, and
- replace her salary with a tax-effective income stream.

It's important to note that limits apply to the amount of income you can receive each year and you can only make lump sum withdrawals in certain circumstances.

How does it work?

Robin's TRP will provide her with an income each year, allowing her to maintain her current living standard. There are minimum and maximum income thresholds she needs to consider though, such as only being able to access up to 10% of her account balance each year.

For this reason, it's important to make sure she puts an appropriate amount of super into her TRP. The good news is Robin will pay less tax on the income payments from her TRP than she does on her salary.

As a result, she won't need to draw down her full pay cut from the TRP. In fact, a pre-tax income of $32,157 will cover her salary reduction of $40,000 as she is entitled to a tax offset on taxable TRP payments.

	Before Strategy	**After Strategy**
Pre-tax salary	$100,000	$60,000
TRP income	N/A	$32,157
Total pre-tax income	$100,000	$92,157
Less tax payable including Medicare levy	$26,447	$18,604
After-tax income	$73,553	$73,553

What's more, when she turns 60 next year the income stream payments will be completely tax-free[3], meaning a TRP payment of $25,400 will cover Robin's $40,000 pay cut.

Tips and traps

It can be tempting to focus on the short term and maintain your current lifestyle when you're working part-time. But be careful you don't draw down your super too quickly and fall short of income during retirement as a result. Your Planner can help you determine your expected length of retirement and the income you'll need each year, so your super lasts as long as you need it to.

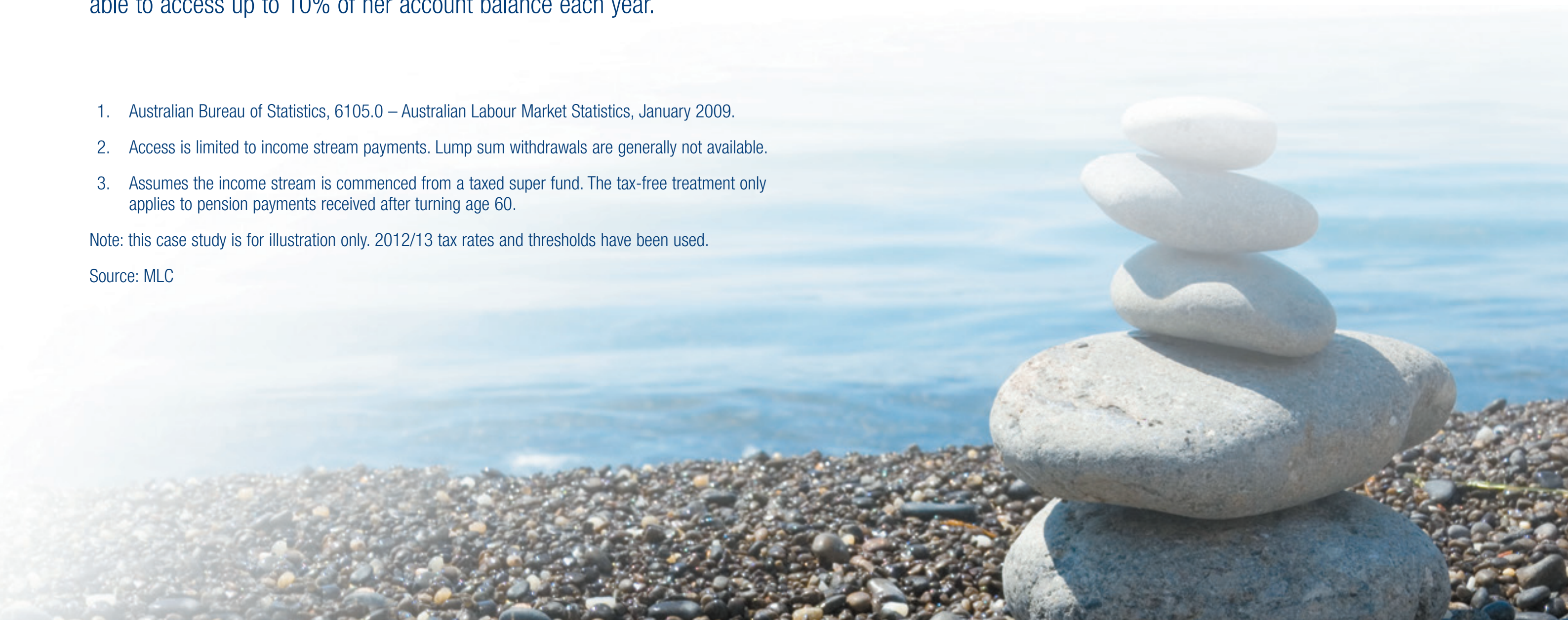
Once you purchase a TRP, you can transfer the money back to super at any time. This flexibility is a great option if you think you might return to full-time work at any point. However, a TRP can still be a smart strategy when you're working full-time and want to boost your retirement income. Some super funds have a minimum account balance, so it's important to check if yours has a limit before you start a TRP.

A TRP isn't always the most effective strategy. If you have investments outside super, you may actually be better off keeping your super as it is and using your other assets to supplement your income. Your Capstone Financial Adviser can help you choose the best option for your situation.

1. Australian Bureau of Statistics, 6105.0 – Australian Labour Market Statistics, January 2009.
2. Access is limited to income stream payments. Lump sum withdrawals are generally not available.
3. Assumes the income stream is commenced from a taxed super fund. The tax-free treatment only applies to pension payments received after turning age 60.

Note: this case study is for illustration only. 2012/13 tax rates and thresholds have been used.

Source: MLC



A new dawn for income investing

Income focused investment strategies have increased in popularity over the past few years as some investors shy away from the higher volatility of traditional investments like shares.

So what's income based investing all about and how do you make the most of this approach to investing?

Short term solution

The objective of income based investing is to deliver a stable and sufficient income stream while at the same time reducing underlying capital volatility.

On the surface, simply shifting into cash and fixed income based strategies aims to achieve this. With term deposits and fixed income funds having delivered returns of 7% to 10% or higher with negligible capital volatility, it seems to be a perfect solution to the problem.

If such returns could be sustained long term, then this could be a reasonable investment solution.

Unfortunately, it's highly unlikely that cash and fixed income based investments alone will generate this level of returns on a sustainable basis in future.

Average term deposit rates have fallen below 6% following interest rate cuts by the Reserve Bank of Australia and bond funds are seeing much lower yields at the moment.

This suggests future returns from these strategies on average are likely to be markedly lower over coming years.

In search of higher yields

However cash and bond strategies are just one element of income focused investing. The Australian sharemarket also contains higher dividend paying share investments.

Apart from a higher potential after-tax return, the benefit of a dividend focused strategy is that dividends tend to grow over time in line with corporate profitability. This growth provides some protection against rising cost pressures.

The potential dividend returns available from investing in the local sharemarket are also relatively quite attractive, provided profits are sustained. The average dividend yield of the Australian share market was almost 5% pa at the start of 2012.

Add on the after tax franking benefits available to retirees then this might be boosted a further 1.5% to 2%. Even more appealing, the higher yielding sectors of the local market are offering dividend yields around 7% to 8% pa or higher at present. Add in franking credits and the after-tax yield rises to closer to 9-10% pa.

Provided dividends can be sustained and grown over the long term, then the yields on offer in the Australian sharemarket would seem to meet many investors' needs.

Balancing yield with volatility

However, there's a potential sting in the tail with this strategy. While some of the higher yielding parts of the Australian sharemarket have also been relatively less volatile capital investments, the Australian banks for instance displayed significant capital volatility in 2011 despite their high yield.

For investors who want higher yields with lower risk, this high volatility could be a problem.

So is it possible to develop strategies which combine higher, more predictable income returns, with lower capital risk on a sustainable basis?

Blending for balance

There are solutions to this, but they're likely to require more sophisticated approaches. Blending a range of investment strategies that deliver sustainable income returns while actively managing capital risk could be an answer.

Such strategies are likely to employ various combinations of cash and bond based investments with dividend focused share investments as well as other income producing strategies such as international shares, credit, absolute return and equity income strategies. This helps maximise the diversity of sources of return as well as minimise investment risk.

If you would like to discuss an income investment strategy, talk to your Financial Adviser who can work out the best approach for your needs.

Source: MLC

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