Your Wealth Bulletin

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Hi,

A month is a long time in both government and financial markets. So given the recent legislative changes to super, as well as high market volatility, this month we thought it appropriate to drill down further into two relevant topics that effect everyone.

In this issue we examine:

- Death & Taxes
- Volatility, Risk and Return

Death and Taxes

New Super Changes

Everybody should now be aware that superannuation withdrawals are tax free for retirees over the age of 60.

But what happens to your money when you die?

If you have dependants, eg. a spouse or children under the age of 18, then they will receive the benefits from the fund tax free.

A valid concern for people over the age of 60 however is if they have children over the age of 18. They are not classified as being dependants. So the issue of concern is that if a husband and wife were to pass away, the adult children will most likely receive the proceeds of the superannuation fund.

The benefits from the super fund, when passed onto the beneficiaries, may now be liable for a 15% 'death tax' on the 'taxable element' of the super fund. The 'non-taxed element' of the fund will pass through tax free.

This is of particular significance given the prevalence of Self Managed Super Funds and assets such as property within the fund. It may be the case that the beneficiary will receive ownership of the property, as well as a 15% tax bill even though the property isn't sold.

For pre-retirees, it may be of benefit to consider boosting the 'non-taxed element' of the super fund.

This can be done via a recontribution strategy prior to retirement. By cashing-out, then cashing-in, this can have the effect of recategorising most of the super components into the 'non-taxed element'.

If that all sounds a bit complex, it will be of no surprise to see pensioners simply withdraw their money from their super fund prior to death if they have no dependant available to receive the funds tax free.

All in all, as a result of these super changes, estate planning is of significant importance when considering your retirement. Your beneficiaries may be liable for unexpected tax bills if you overlook this aspect of your financial plan.

If you would like to discuss estate planning further, please feel welcome to call us on (02) 9525 0777.

Market Volatility

What to expect

On July 19, 2007 the S&P 500 in the US closed at 1553. By August 15th it had slid to 1407. A drop of almost 10%!

The drop was fuelled by investors fleeing from companies exposed to highly leveraged credit. Headlines from the media reported huge losses in hedge funds as investors fled all risky assets, the kind of assets hedge funds often buy.

These sort of wild fluctuations appear to occur far more often than what they should. Professor Eugene Fama of the University of Chicago studied the historical distribution of stock returns. Here is what Fama found: "If the population of price changes is strictly normal, on the average for any stock...an observation that is more than five standard deviations from the mean should be observed about once every 7,000 years. In fact, such observations seem to occur about once every three or four years."

What does this all mean for the average investor?

Your average stock on the market, in theory, isn't supposed to move too much at all, but with human emotions having such an influence, we see shares moving wildly up and down on a very regular basis (by 5 times more than the average movement).

Also worth considering are the following facts of US market volatility:-

- From 1926-2006, 23 out of 81 years ended up with negative returns for the year
- In 9 of those years, the losses exceeded 10%
- In 5 of those years, the losses exceeded 20%
- In 2 of the years, the losses exceeded 30%
- And in 1 year, the loss exceeded 40%

What history is telling us is that the sharemarket is a risky asset class. And, those risks show up regularly and severe drops are not uncommon.

This confirms the adage of 'risk equals return'. It is why the risk of severe losses in equities is rewarded by returns greater than those offered from bonds or term deposits.

Typically, investors are risk averse. To entice them to invest into the sharemarket, stocks must be priced to provide higher expected returns than other asset classes.

Therefore, it is not a question of 'if' the risks will show up. The only questions (to which no one has the answers) are 'when' the risks will appear, how dramatic the decline and when the decline will end.

When Risks Show Up The recent flight to quality by investors was from junk bonds and low credit rated bonds. This confirms that the only safe haven during market declines is typically highest quality fixed income investments such as government bonds and highly rated corporate bonds.

This is why it is crucial to include a portion of your portfolio into this asset class. Fixed income securities are not there to provide 'high returns', their role is to reduce volatility. As we discussed recently in a newsletter about 'decompounding', with decreased volality comes the potential to increase your bottom line dollar figure in the long term.

In terms of the hyped hedge fund and their promotion of making money when the market is going down? Larry Swedroe (US) writes recently, 'it is also important to note that the risks of hedge funds, which supposedly offer the benefit of low correlation, tend to rise during crises. The reason is that many hedge funds attempt to achieve high returns by investing in risky and illiquid assets. Thus, just when you need them to provide their so-called hedge, instead what happens is the risk appears. This is exactly what happened in the summer of 1998, with an encore performance in the summer of 2007. This is just one of the many reasons why investors should avoid hedge funds. (There are many others including their failure to deliver on their "promise" of greater risk- adjusted returns.)"

The lesson here is that investors can expect markets to be highly volatile. They have been acting that way for many decades. The true offset of this volatility is high quality fixed income investments, not 'hyped' market hedge funds.

Investors also often adopt the strategy of 'market timing' by attempting to move in-and-out of the market to attempt to avoid market declines. We will examine this topic in more detail next month.

If you have any queries about this month's newsletter or would like to discuss your financial situation in more detail, please feel free to email or call our office on (02) 9525-0777. If you would like to forward this email to a friend, click on the forward email link below.

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