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WELCOME

Welcome to the latest edition of our quarterly newsletter 'Informed Investor'. We hope you find the articles in this issue useful and informative.

As always, should you have any questions please feel welcome to contact us.

ECONOMIC UPDATE

INTRODUCTION

Investors continued to focus on rampant inflation and, in turn, potential changes in monetary policy settings.

By the end of January, five interest rate increases in the US had been priced in to markets; a more aggressive tightening in policy settings than had been anticipated previously.

These evolving expectations saw bond yields rise in all major regions – resulting in negative returns from fixed income markets – and spooked share markets. Major equity indices in the US, Europe and Australia all closed January substantially lower.

FURTHER INFORMATION

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ECONOMIC UPDATE

CONTINUED

AUSTRALIA

The Reserve Bank of Australia expects inflation to continue to trend higher in the short term. CPI seems likely to be above the 2-3% target range, due to a combination of effects including higher petrol prices and interruptions to global supply chains.

The higher inflation prints are expected to be temporary, however, rather than being more structural in nature. Policymakers remain unconvinced that inflation is 'sustainably within the target band' – the stated hurdle for interest rates to be raised. Accordingly, the Reserve Bank is likely to be more patient than current market pricing suggests when it comes to raising cash rates.

Officials again made specific reference to stronger wage outcomes being required for inflation to be sustainably within the target range. With the unemployment rate forecast to fall only modestly during 2022, the central case appears for only a gradual pick up in wages.

All of this suggests interest rates could start to be raised in Australia in 2023, rather than this year. That timing could be brought forward if wage outcomes surprise on the higher side in the near term.

NEW ZEALAND

Like elsewhere, there was an ongoing focus on inflation. CPI quickened to a 31-year high of 5.9% in the December quarter, driven by rising energy prices, higher prices for new and used cars, and rising rents and construction costs.

Consensus forecasts suggest unemployment fell in the December quarter. With labour shortages in some areas due to border closures and a lack of immigration, wages are rising.

House prices were also up an eye-watering 27.6% in 2021.



All of this suggests policy settings could be tightened further in the months ahead. The Reserve Bank of New Zealand has already raised interest rates twice in the past few months, but further increases are anticipated this year.

US

With inflation running seemingly out of control, it has become clear that interest rates in the US will be raised sooner rather than later. Headline CPI has risen to an annual rate of 7.0%, the highest level in nearly 40 years. Most investors are now expecting officials to lift the Federal Funds rate in March. It remains to be seen whether policymakers will raise the official interest rate by 0.25%, or opt for a more aggressive 0.50% hike.

More importantly, consensus forecasts now indicate the Federal Funds rate will be raised by around 1.25 percentage points this year. This will be the start of the 'policy normalisation' process, following two years of Covid-related zero interest rates.

Less than 200,000 new jobs were created in December – the lowest monthly total of 2021 – although the US economy added nearly 6.5 million jobs in the year as a whole.

Despite the buoyant job market and rising wages, consumer spending has been subdued recently due to Omicron.

EUROPE

German officials reported GDP contracted 0.7% in the December quarter, raising concerns about a possible recession in Europe's largest economy. The latest sentiment gauge fell to its lowest level in nine months, as pandemic restrictions dampened confidence levels.

More encouragingly, economic growth in France and Spain was ahead of expectations.

In aggregate, Europe appears to be recovering from the pandemic more slowly than the US. The IMF has lowered its outlook for the euro-area for this year, and suggested inflationary pressures in the region will persist. Tensions between Russia and Ukraine threaten to send energy prices in the region even higher, which could hamper corporate and consumer spending. Inflation remains a concern in the UK too, having risen above 5%/year in December. Interest rates seem likely to be increased further in the months ahead, following December's initial hike.

ASIA

Inflationary pressures are being seen in Japan, a country that has grappled with deflation for most of the past 20 years. Bank of Japan officials raised their official inflation expectations for the first time since 2014. Growth in China is expected to come off the boil this year and next, decelerating to an annual pace of around 5.0%. That compares with GDP growth above 8.0% in 2021, and a rate of between 6% and 7% in the five years pre-Covid.

AUSTRALIAN DOLLAR

The Australian dollar often underperforms during periods of 'risk-off' market sentiment, and January was no exception.

The 'Aussie' lost ground against the US dollar, falling 3.1% to a little over 70 US cents.

The currency depreciated by a similar margin against a trade-weighted basket of other international currencies.

AUSTRALIAN EQUITIES

Australian equities experienced their worst month in January since the coronavirus pandemic began, and endured the worst start to a calendar year since the Global Financial Crisis.

The S&P/ASX 200 Accumulation Index declined 6.4%. Valuations came under pressure from concerns about potential interest rate hikes, rising inflation and geopolitical tensions overseas. IT stocks fared particularly poorly. All constituents in the sector lost ground, with WiseTech Global, Altium and Xero all declining by more than 20%.

The Energy (+7.9%) and Materials (+0.8%) sectors were among the few that moved higher in January. Both sectors were supported by strong commodity prices. Iron ore and oil both moved around 20% higher in AUD terms over the month. Iron ore benefited from expectations of growing Chinese steel demand, thanks to anticipated increases in infrastructure investment, along with restocking demand ahead of the Lunar New Year holiday period.

The 'risk-off' sentiment had a particularly adverse influence on small cap stocks, as investors favoured the relative safety typically associated with larger companies. The S&P/ASX Small Ordinaries Accumulation Index declined 9.0%, with fewer than a quarter of constituents delivering positive returns.

LISTED PROPERTY

Global property securities struggled, with the FTSE EPRA/NAREIT Developed Index returning -2.7% in AUD terms.

Outperforming regions included France (+3.3%), Germany (+1.6%) and Hong Kong (+0.7%). The laggards included Sweden (-10.3%), Australia (-9.5%) and the US (+6.8%).

Property securities were affected by inflationary expectations and an uncertain economic policy outlook.

GLOBAL EQUITIES

With weakness extending across most major share markets, the MSCI World Index closed the month 5.3% lower in local currency terms (and by a more modest 2.3% in AUD terms).

The tech-heavy NASDAQ in the US declined 9.0%, as investors banked profits from 2021's 22% rally. The broader S&P 500 Index in the US closed January 5.2% lower, with stocks in most industry sectors losing ground.

European bourses were also subdued, partly owing to rising geopolitical risk in Eastern Europe. Fears that Russia could invade Ukraine persisted throughout the month. In aggregate, the MSCI Europe Index lost 3.2%. Swiss stocks were notable underperformers, closing 5.9% lower.

The UK market bucked the negative trend, with the FTSE 100 Index adding 1.1%.

Asian markets were mixed. The Chinese market was down 7.6%, for example, while Hong Kong's Hang Seng closed up 1.7%, in spite of the introduction of various new virus-related restrictions.

GLOBAL AND AUSTRALIAN FIXED INCOME

10-year government bond yields in the US rose 27 bps in January. This set the tone for bond markets globally, and resulted in negative returns from most major fixed income indices.

At around 1.80%, 10-year Treasury yields are now back to their levels from the end of 2019, before Covid-19 started to affect financial markets. 10-year Australian government bond yields closed the month 23 bps higher, at 1.90%.

GLOBAL CREDIT

With equity markets struggling, it was unsurprising to see credit spreads widen. This occurred in both the investment grade and high yield sub-sectors, resulting in negative returns from global credit products.

Despite headwinds including lockdowns and other virus-related closures, supply chain disruptions, and labour shortages, default rates were very low globally in 2021. According to Moody's, just 54 companies worldwide missed scheduled bond repayments over the year – the lowest annual total since 2011.

Source: Colonial First State



CONSTRUCTING A RETIREMENT PORTFOLIO IN A LOW RETURN WORLD

Portfolio construction is a much-used term that can be misunderstood.

Fundamentally, the term portfolio construction refers to the process of selecting investments to create the optimal balance of risk and return.

By mixing different types of investments and different asset classes, portfolios can be built in a way that maximises the return for any given level of risk.

This concept of risk is fundamental to portfolio construction. The key to effective portfolio construction is understanding that each individual experiences risk differently and investment needs change dramatically as people's priorities change over the course of a lifetime.

RISK TOLERANCE

Depending on what stage of life they are at, individual investors can have quite different goals.

An investor early in their career can afford to seek higher returns from their investment portfolio by taking a higher level of risk because they have more time to make back any downturns in markets.

They also have less need for income from their investments than someone approaching or in retirement and can weight their portfolio towards growth assets.

A younger investor can be less concerned about inflation than a retiree because they can rely on wages growth that can maintain their purchasing power.

They can also afford to lock up investments for a longer period without worrying about liquidity because they have time

before they need to draw down on their assets.

In contrast, retirees tend to be more concerned about capital preservation because they need to draw on their asset pool throughout their retirement.

As they are no longer earning income from work, they need to draw income from their portfolio. This means they should consider weighting their portfolios towards income-generating assets.

Any increase in inflation erodes a retiree's purchasing power as it costs more to maintain standard of living which means their capital can be eroded faster than planned.

And liquidity is critical for a retiree as assets may need to be sold quickly – for example if there is a medical emergency – without punitive valuations.

The concept of sequencing risk is also a critical difference between early and late-stage investors.

SEQUENCING RISK

Sequencing risk refers to the risk of being forced to sell investments after a fall in valuations.

A younger investor can typically ride out market volatility and even buy more assets when valuations are low.

However, late career investors and retirees who are forced to sell assets at low prices to fund their lifestyles have no way of regaining the lost value.

A sensible portfolio construction process can protect against this.

HEDGING RISK

A question that often comes up is the role of downside protection in portfolio construction. The answer is different depending on where an investor is at in their investing journey.

Take the example of a pre-retiree and a younger investor with portfolios split equally between equities and bonds going into the global financial crisis (GFC) – with and without downside protection using options strategies.

Without downside protection, the retiree would have seen a pullback in the value of their assets of about 25 per cent and, because they were drawing down on their assets to live their life, they would not have been able to fully participate in the subsequent recovery.

Had they used downside protection on their portfolio, they would have been back on track by 10 years later.

The same is not true of the same strategy deployed by a younger investor. Without downside protection, young investors just keep buying into the market through a downturn and continue to accumulate assets.

But with downside protection – which comes at a cost – they see a drag on their returns, lowering their ultimate savings. It's a reminder of the difference between younger and older investors.

Human beings also have the potential to make mistakes in their investing lives. If a retiree investor facing the same kind of GFC drawdowns suddenly became risk-averse and shifted their portfolio to 30:70 equities and bonds, this would be an understandable and apparently rational decision to preserve assets.

But markets recover. If that retiree waits until the storm passes and takes three to five years to switch back their allocation to 50:50, they would be 30 per cent worse off than if they did nothing at all.

ASSET ALLOCATION

So, what assets should retirees look for?

In our view, the key is to seek out desirable risk attributes and not simply take the approach of investing by asset class.

In Australian equities for example, franking credits offer a good income stream for retirees by refunding the tax paid by the underlying companies. It should also be noted, however, that in seeking a higher exposure to Australian equities in pursuit of franking credits, a portfolio will acquire other concentrations of risk, for example: exposure to China. Good portfolio construction should consider and diversify away these concentrations.

In direct assets, infrastructure offers good opportunities for retirees. Many infrastructure assets earn a return on an availability basis regardless of actual usage or economic conditions, providing a stable income.

The key consideration for direct assets is liquidity, as holding large allocations of illiquid assets could mean having to disproportionately sell down liquid assets, like equities, at an inopportune time if larger

sums of cash are needed for, say, a medical emergency.

For bonds, the traditional defensive characteristics may not be available in a world of near zero interest rates and the potential of rising inflation.

In the last 30-40 years we have seen a terrific run in markets, particularly with bond rates coming down from as high as 16.5 per cent in the case of 10 year Australian government bond yields almost 40 years ago to near zero now. The performance was further buoyed by lower tax rates, falling tariffs and the rise of globalisation.

The corollary of this is that throughout those 40 years, forward return expectations have been declining. In fact, a fund with a traditional asset allocation split 60:40 between equities and bonds is near its highest ever valuation level.

We believe this means return expectations from investment portfolios should be expected to be lower going forward until interest rates normalise.

Inflation is also a looming threat to portfolios. US annual consumer price inflation pushed up beyond 6 per cent in October of 2021 and there is a risk that price pressures associated with deglobalisation and decarbonisation defy the widely held 'transitory' thesis and stick around.

GOALS-BASED INVESTING

Given lower expected returns and higher inflation, what's the right portfolio response?

Doing nothing is one approach – simply accept that returns are going to be lower. Another approach is to increase risk – adding riskier, more leveraged asset classes will improve the prob-

ability of getting a return but also increase the probability of losing money.

A third approach is to lower your expectations. This means not changing how portfolios are constructed but accepting the likelihood of lower returns and perhaps adjusting things elsewhere in your life accordingly. In our view, this isn't of much use or comfort however to today's pre-retirees and retirees.

And the final – and more important – approach is to adjust strategy to those areas most likely to achieve objectives. This could include taking a goals-based approach to investing.

For example, a retiree could decide that rather than taking a traditional asset allocation approach to portfolio construction, they instead want to take on the goal of protecting and maintaining their standard of living in retirement. That goal might be measured by providing returns equal to the consumer price index plus 3.5 per cent as an example.

By focusing on the desired outcomes rather than simply considering traditional asset class allocations, investors can consider including alternative investments and strategies that may not be available under a traditional approach.

Source: AMP Capital



SHOULD YOU USE PROPERTY TO FUND YOUR RETIREMENT?

While property may seem like a good way to build and hold wealth, is it a practical way to fund your retirement?

Superannuation, shares, property, cash, other investments; a dizzying number of options are available when it comes to living comfortably through retirement.

Financial advisers often promote a diversified portfolio to reduce the risk of concentrating 'all eggs in one basket'. Still, Aussies love their property, with more than 2.2 million of us opting for investing in property, with almost 60% of those aged 50 or over holding property investments.

Aside from simply owning a secure place to live through retirement, investing in property can also provide regular post-work income and might offer some assurance as a 'safe' investment option. Property is a physical asset and can seem less volatile than other investments, particularly when heading into a phase of life that holds uncertainty and where you may think: "What happens if I outlive my savings?"

But different risks and tax obligations in retirement can alter the attractiveness of investments and, when it comes to property, there are a range of strategies that offer different pros and cons when using it to fund retirement.

LIVING OFF RENTAL INCOME FROM AN INVESTMENT PROPERTY

On the surface, living off rental income in your retirement is an attractive prospect. But you may need to first make sure the lifestyle you want doesn't exceed your investment property's returns, taking into consideration any mortgage repayments, taxes and maintenance costs, as well as factoring in for times when the property may not have tenants.

Many people find they need multiple properties in their investment property portfolio to generate enough income to support their retirement lifestyle.

PROS OF LIVING OFF RENTAL INCOME

Capital appreciation:

If you've owned a property for a while or have made significant improvements, chances are it may have grown in value – and may continue to do so. Growth in value can also mean higher rental rates and returns.

Interest rates are at all-time lows:

Which means low mortgage repayments, if you have them.

Outgoings can be low:

If you're healthy and handy, you can leverage your free time in retirement to save maintenance costs by doing your own property management and minor repairs.

Holiday ahoy:

Many Australians choose to purchase investment properties in holiday locations. When leased, your tenants provide an income stream; when not, you have an instant holiday house for yourself or perhaps a short-term rental.

CONS OF LIVING OFF RENTAL INCOME

Ongoing costs can pile up:

In addition to anticipated outlays – property management, insurance and rates – you risk unexpected costs like emergency repairs and oft-forgotten long-term appliance or structural replacements.

Income from your investment property may be subject to income tax:

This will depend on the net amount per financial year – and the amount and type of any other income.

Liquidity is restricted:

If you need funds unexpectedly e.g. for medical costs, to take a holiday, or for emergencies, you can't sell a single room of your investment property as you can with shares of stock – the whole thing has to go, and it will take some time before you get the actual sale proceeds.

Your income isn't guaranteed:

The rental market can change, and it might mean that your property can be empty for periods of time.

LIVING OFF EQUITY

This option essentially sees you paying-off as much as you can on your property while working (reducing the loan-to-value ratio) and then funding your retirement by borrowing against the equity (the value of your home, less any mortgage) if and when you need it.

A number of strategies are available, including home reversion, reverse mortgage and home equity release.

Keep in mind that the amount of money you can access depends on your age, the value of your home and the type of equity release.

PROS OF LIVING OFF EQUITY

It's tax free:

You don't have to pay tax on this 'income stream' as it is effectively a loan.

You can tailor the amount of equity you borrow:

Whether it's regular payments, a lump sum, line of credit or a mix.

You don't have to sell:

If the equity is in your own home, you get to keep living there and you don't have to make repayments while you do.

Negative equity protection:

In other words, you will never end up owing your lender more than your home is worth if you take out a new reverse mortgage.

CONS OF LIVING OFF EQUITY

There are costs involved:

Application, service and end-of-agreement fees may apply. Check with your lender as they may vary from lender to lender.

A volatile market:

This strategy only works well if your property is increasing in value.

You are converting capital to debt, for yourself or your beneficiaries:

Some dub this investment strategy "spending wealth, rather than cash flow."

The amount you can 'borrow' is restricted:

If you're 60, you can only access 15-20% of the value of your home. As a guide, add 1% for each year over 60. Over time, your payback interest rates may be greater than an average home loan.

With home reversion, you 'sell' a share of your home usually for well under market value.



SELLING PROPERTY TO FUND RETIREMENT

To sell or not to sell? It's a question many Australian homeowners face as they enter retirement, regardless of whether it's the family home or an investment property.

If this is to be your major income through retirement, check that any profits you reap will equate to comfortable golden years.

Also consider the effects of re-buying or renting in the same market if you're downsizing.

PROS OF SELLING PROPERTY

Selling your property may mean you have an increased cash flow:

You can use it to pay off debt or invest in shares or in managed superannuation funds, which may provide additional tax benefits and liquidity.

You may not have to pay capital gains tax:

This may apply if your property is your primary residence, or you purchased it before September 1985.

CONS OF SELLING PROPERTY

Capital gains tax:

When selling an investment property you've never lived in, you may be liable for capital gains tax on any profit.

All the costs of selling a property:

Real estate agent fees, legal fees, moving costs and so on.

Timing:

If you need to sell in a hurry to fund your retirement, you may not be selling into the best market. Liquidating during a market downturn can mean a significant hit to your retirement income.

On the other hand, selling at the top of the market could mean boosting your super balance with a large lump sum, but remember the pension transfer balance cap limits the amount you can invest in a tax effective retirement pension.

Your bank balance:

Selling your home may impact the amount of Age Pension you receive.

No one-size-fits-all approach works when it comes to using property for retirement. With so many factors influencing your decisions, it's wise to consider your options and speak to your financial adviser.

Source: AMP



HOW DOES YOUR PENSION LIVE ON AFTER YOU DIE?

Account-based pensions offer a flexible and tax-effective method of drawing a regular income stream from superannuation.

They are an essential part of your overall retirement strategy and are usually used from retirement until death. But what happens to your tax-free account-based pension when you do die?

Superannuation does not automatically form part of your Will unless a Death Benefit Nomination is completed to that effect. In this article we examine the nomination of an individual beneficiary, where the nomination of a member's estate and a reversionary beneficiary nomination is not in place.

What are your beneficiary's options?

The short answer is it depends. To receive your account-based pension your nominated beneficiary may have two options:

1. Commencing a death benefit pension; or
2. Receiving a lump-sum payment.

Both options are subject to additional eligibility criteria. Let's briefly explore both options with our focus being option 1, commencing a death benefit pension.

Option 1: Commencing a death benefit pension

Features of a death benefit pension

A death benefit pension can basically be considered as allowing your account-based pension to live on after you die, for the benefit of your eligible beneficiary. Features of this pension are much the same as those for an account-based pension.

Arguably, the most attractive feature is the tax-free nature in which the assets will reside. Recipients are required to receive a minimum cash pension payment each year which is based on their age and pension balance as at the previous 30 June.

Death benefit pensions can also be rolled into another fund at any time, however, they retain their identity as a death benefit. Therefore, a death benefit pension cannot be combined with other pensions or rolled back to the accumulation phase.

Is your nominated beneficiary eligible?

Generally, only your spouse is eligible. Adult children and your legal personal representative (your estate) would have to receive the benefit as a lump-sum withdrawal, i.e., the assets are removed from the superannuation environment and subject to tax on the taxable component.

A dependent child (or children) may also receive a death benefit pension in limited circumstances; if they are under age 18; under age 25 and financially dependent on you; or have a prescribed disability.

Transfer Balance Cap

Another important matter to consider is your eligible beneficiary's Transfer Balance Cap (TBC).

To reiterate, the TBC is a lifetime limit on the total amount of funds that can enter the tax-free pension phase, currently at \$1.7 million. Where your beneficiary has already commenced an account-based pension and does not have a sufficient remaining TBC to receive the death benefit pension, they may roll back their existing account-based pension into the accumulation phase to create room for the death benefit pension.

Option 2: Receiving a lump-sum payment

The alternative is to receive the amount as a lump-sum payment. With this option, the funds exit the superannuation environment. The benefits may be cashed as either in-specie or cash depending on your fund's governing rules.

Conclusion

The death benefit pension option presents an opportunity for your eligible beneficiary to maximise the total amount of funds held within superannuation.

While there are limitations on who can exercise this option and matters complicated by TBC, it is still worth considering as the assets will reside in a concessional tax environment.

Source: Bell Potter