

Make the most of interest rate cuts



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In September the Reserve Bank delivered its first interest rate cut since December 2001, providing some welcome relief for home buyers and people paying off mortgages. It signalled the end of the tightening cycle, and there is hope that further cuts will follow.

Most people will find that the 0.25% cut in mortgage rates will deliver only a modest reduction in repayments. For example, new home buyers Pete and Rosie found themselves saving \$34.11 each month when the interest rate on their 25-year, \$200,000 mortgage dropped from 9% to 8.75%. That's about enough to buy each of them a weekend latte at the local café. Still, little things add up. Stashed away in the cookie jar, that \$34.11 each month would amount to over \$10,200 after 25 years.

Pete and Rosie's bank allows them the option of maintaining their current level of loan repayments, so they decided that they can cope with instant coffee at home. In this case, the monthly addition of \$34.11 cuts nearly two years off the term of their loan (20.35 months to be precise), and saves them \$34,160 in interest.

It's no surprise then that the higher mortgage repayments provide a better outcome.

To be fair, we need to compare this result with what could be achieved if the interest saving was put in the bank rather than the cookie jar. Pete and Rosie examine the option of contributing their mortgage savings to a high interest cash account paying 7.5% pa.

However, they realise that the interest on this account will be taxable. They are both on a 31.5% marginal tax rate, including Medicare levy, so their "after-tax" rate of interest drops to 5.14%.

In comparison, the additional payments on their mortgage are giving them an after-tax return of 8.75% pa.

It's no surprise then that the higher mortgage repayments provide a better outcome. In Pete and Rosie's case, the net benefit is more than \$15,800 over the life of their home loan.

If interest rates are cut further, as is widely anticipated, the benefits just get bigger. A further 0.25% cut will deliver Pete and Rosie interest savings of more than \$61,000 if they maintain their original repayments. That's a lot of lattes with which to celebrate paying off their mortgage!



Avoid the churn

It's no secret that investment markets are in a bit of turmoil at the moment. Many people will have received their superannuation statements for the last financial year, and most will have experienced a negative return.

In previous editions we've discussed the ups and downs of investment markets, and the importance of sticking to a sound strategy. Even so, the current conditions may mislead many people into thinking that they can get better investment returns elsewhere. This can lead to an expensive version of musical chairs.

It goes like this. Disgruntled investors switch their superannuation fund, or sack their current financial planner and find a new one. If the markets then recover, as they invariably do, they'll feel happy about the decision they've made. What they overlook is that their new planner or superannuation fund is likely to have lost some of their disgruntled clients.

This may seem like a relatively harmless reshuffling of planners, funds and clients, but it usually comes at a cost. Clients may incur exit and entry fees, transaction costs and capital gains tax. Unless there was a genuine problem with the original planner or product, most people would be better off staying put.

Unfortunately, there are some unscrupulous operators who take advantage of market downturns to prey upon anxious and less knowledgeable investors. At the extreme end of unconscionable behaviour lie the unlicensed schemes promising spectacular returns. These are often fraudulent, and their aim is the outright theft of investors' money. Be aware that all providers of financial products and advice must operate under an Australian Financial Services Licence (AFSL).

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A more time-honoured tradition, even within parts of the mainstream financial planning industry, is the practice of "churning". Many financial planners rely on entry fees and ongoing commissions for their income. One way to boost that income is to regularly transfer clients from one product to another.

Each switch means a new entry fee, which translates into extra commission for the planner or product adviser. Entry fees don't apply to all investment funds; however, investors also need to watch out for "nil entry fee" options that attract higher ongoing fees, at least for the first few years. These can be a form of entry fee by stealth.

It's easier to churn clients who are dissatisfied with their current fund as they may be more inclined to believe promises of better returns. Advisers have a legal obligation to explain why the switch is beneficial to the client, but it isn't difficult to come up with a reason that sounds valid and would be difficult to disprove.

To be fair, commissions aren't necessarily a bad thing, and many commission-based planners do operate to high ethical standards. However, commission-based fee structures do create a potential for bias, so when presented with recommendations to change investment funds, it's important to ensure that there really is a material benefit to you.

Industry Superannuation Funds don't charge entry fees, and don't pay commissions to advisers. IFFP financial planners charge a fee based purely on time taken to address a client's needs. This means that, apart from our simple moral objection to churning, our planners have no financial incentive to engage in the practice.

If you have any concerns about the performance of your investments, talk to an IFFP planner. Call 1300 138 848 to make an appointment.

Editorial

Everyone with a home loan will have welcomed the interest rate cut that the Reserve Bank delivered in September. Further cuts are anticipated, but they are far from a sure thing. There are several reasons why the RBA may maintain rates near their current level.

Inflation is still a problem, and the RBA doesn't expect it to fall back within the Bank's comfort zone of less than 3% until 2010. Declining oil prices may help, but with the Australian dollar also falling, lower oil prices aren't being reflected at local petrol pumps. The falling dollar also pushes up the price of imported goods. This places upward pressure on inflation, limiting the ability of the RBA.

Fiscal policy—the amount the government takes from us in taxes and returns to us through government spending—will also influence the RBA. Tax cuts and higher government spending tend to be inflationary. On the other hand, if the government maintains or increases the budget surplus, some

heat is taken out of the economy, allowing for a further easing in interest rates. It's worth noting that, without control of the Senate, the government may not get its own way on fiscal policy.

Clearly, the RBA faces a difficult balancing act. Business investment is booming while retail sales are in trouble. Business confidence is down, but demand for resources remains high. In the face of uncertainty, it makes sense to maintain a conservative approach to debt. Don't bank on further cuts just yet. If you are undertaking new borrowing, make sure that you can service your loan—even if rates start to rise again.

As we were about to go to print, the US financial crisis deepened and world markets became even more volatile. To help you through these difficult times, we've provided some dos and don'ts on page 4.

David Haynes
General Manager

The value of advice

What is the real value of financial advice? Some people think it lies in getting the best investment returns, but the fact is that, over the long term, it is extremely difficult to do better than the market.

The real value of advice lies elsewhere. It begins with the creation of a tailored, long-term strategy that will help you build your financial independence and achieve your goals. A good financial planner will also provide value by helping you stick to your strategy, so you avoid making some simple but costly mistakes along the way.

To illustrate the dollar value of a good strategy, we've looked at a typical couple planning their retirement.

Robert, age 55, earns an income of \$55,000 a year. His partner Trish, also 55, earns \$35,000. They currently need \$60,000 a year to live on. Both receive standard employer superannuation contributions of 9%, and their funds grow at 8% pa (nominal growth rate). They currently have a combined superannuation balance of \$162,000.

If this remains their retirement strategy, their financial position will follow the orange line on the graph shown.

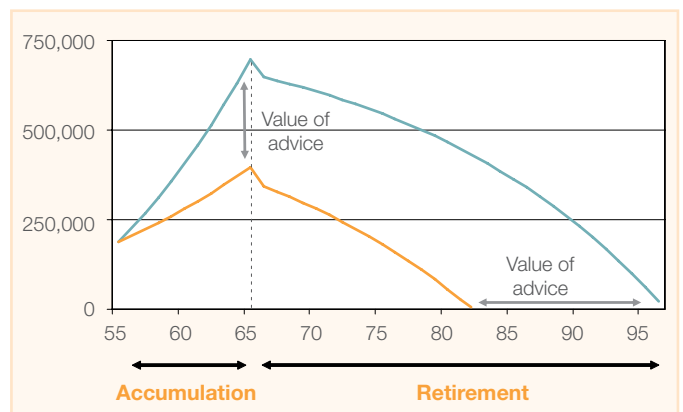
At age 65 they will have accumulated \$352,000 (in today's dollars) in retirement assets. This amount will provide them with an annual income of \$50,000 for around 17 Years, inclusive of the Centrelink Age Pension entitlements.

Robert and Trish make an appointment with an IFFP financial planner. The Planner prepares a Statement of Advice recommending a number of compatible superannuation strategies:

- > They both make non-concessional contributions of \$1,000 each year to their superannuation funds. This provides them with access to the government co-contribution.
- > Robert commences a Transition to Retirement pension using \$99,000 from his superannuation fund (20% tax-free component). He draws the maximum pension each year, which is 10% of the account balance.
- > This additional income allows Robert to salary sacrifice \$33,000 each year into superannuation. The favourable tax treatment of his pension and the tax benefits of salary sacrifice allow Robert and Trish to cover their living costs, while slashing Robert's income tax bill, and boosting their retirement savings.

The results of the adviser's recommendations are revealed by the teal-green line on the graph.

Additional assumptions: All calculations are in today's dollar values. Income and employer superannuation contributions have been indexed with inflation, and inflation is assumed at 3%. Robert's superannuation pension is 20% tax free/80% taxable. Information based on current marginal tax rates and Centrelink figures.



At age 65 they will have \$646,000 in retirement assets, a boost of \$294,000! This will support a retirement income of \$50,000 per year (inclusive of Centrelink Age Pension entitlements) for over 30 years, 13 years longer than if they hadn't sought advice,

Of course advice comes at a cost, but compared with the long-term returns, it would certainly have to be one of the best investment decisions Robert and Trish could have made.

To find out what an IFFP planner can do to grow your retirement savings, call 1300 138 848 to make an appointment.

A good financial planner will also provide value by helping you stick to your strategy, so you avoid making some simple but costly mistakes along the way.



Dos and don'ts for troubled times

Just as many commentators were saying that the worst of the sub-prime crisis was over, September saw several major US financial institutions come close to collapse. This created turmoil on global investment markets, adding to the concerns of already stressed investors.

We've prepared the following list of dos and don'ts to help you navigate through these stormy financial waters.

For further information, consult the *Nowhere to hide!* fact sheet available at iffp.com.au.



DO	DON'T
<p>Continue salary sacrificing into super and/or making additional contributions. Super is still one of the most tax-effective investments. Focus on the benefits and strong historical performance rather than short term setbacks.</p>	<p>Forget that super is a long term investment. Ignore the 3, 6 or 12 months returns. Focus on the 3, 5, 7 & 10 year returns – these give you a much more accurate indication on the true performance of your fund.</p>
<p>Be wary of people or products promising unrealistic investment returns. During periods of market uncertainty, some people will be keen to help you swap investment/ super accounts, promising bigger and better results. This is often referred to as 'churning' and is very profitable for them – they often earn commissions on new accounts.</p>	<p>Be pressured into making any major investment decisions. Don't be afraid to ask questions and to say NO. It is your money, your future, so you don't need to do anything that you are not comfortable with. The old adage usually remains true – if it sounds too good to be true, than it probably is!</p>
<p>Make sure you get what you really need from your super. Some products justify high fees and charges because of their many 'bells and whistles' features that the average investor doesn't understand and will never use. Most of us are usually fairly happy with a fund offering good returns over the long term, low fees, well priced insurance options and online access.</p>	<p>Dash for Cash. Seek professional advice before making any sudden investment moves. If you are very worried about market volatility at the moment you should talk to your planner or your fund. One option may be to direct future contributions into a cash portfolio until the market recovers.</p>
<p>Take the opportunity to consolidate your super accounts into one account. You will reduce your fees and make your super easier to monitor. For most of us, any more than one super account is one too many. Contact your Industry Super Fund if you need help.</p>	<p>Ignore the fees you are being charged. If you are paying high management fees and trailing commissions to an adviser you haven't seen or heard from for years, now may be a good time to ask... what exactly am I paying for? Remember – performance is not guaranteed... fees are!</p>
<p>Think carefully before making any sudden investment decisions or changes. During periods of market uncertainty, the best option for most people is to 'hold their nerve'.</p>	<p>Think DIY Super is easy! Self managed funds (SMSFs) are fine for some, but unless you have at least \$300,000 in super and the time, knowledge and interest to actively monitor your own investments you may find yourself paying significantly more in fees for much lower returns.</p>
<p>Prepare yourself for more volatility in the market. It is likely that there will be more ups and downs before markets stabilise.</p>	<p>Put off retirement without seeking professional advice. Remember, if you transfer your money from your super into the same asset classes in your pension account, you won't have crystallised your losses and will still be in the position to benefit from recovery in the market.</p>

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Industry Fund Financial Planning:
1300 138 848
iffp.com.au