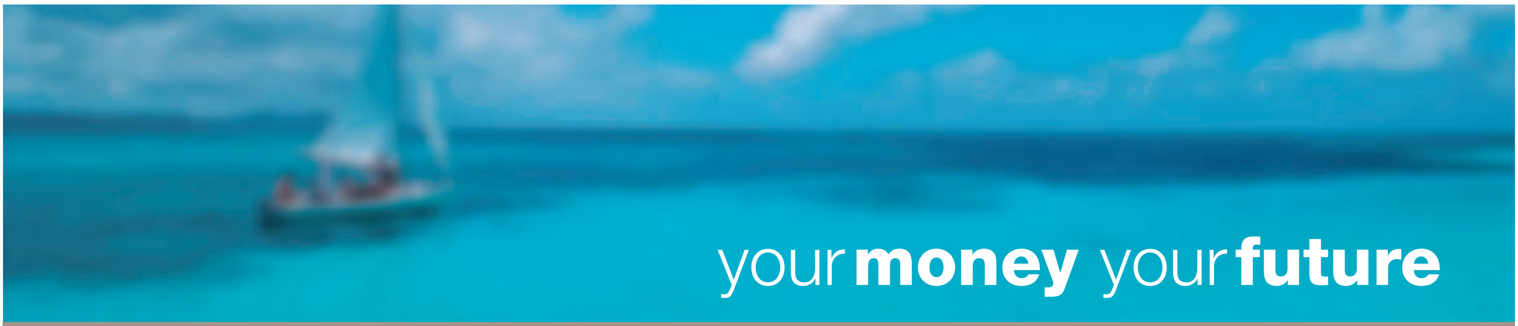

FINANCIAL PLANNING NEWSLETTER

The costs of living

Increases – or changes in the way we live?

Australia may have the third lowest cost of living in the developed world after the US and New Zealand[1] and relatively stable CPI figures yet it seems many Australians are quite concerned about a possible leap in basic living costs. A recent capital city newspaper reader survey found that 81 per cent of those responding believed that the true cost of living was way above the recent annual consumer price index (CPI) figure of 3.3 per cent (or a still modest 2.6 per cent, adjusted for volatile items).[2]

For many of us, the main cause for concern seems to be recent increases in the price of water and power, the two utilities we can't live without and whose bills we receive every quarter. The most recently published Nielsen Research Global Online Consumer Survey (June 2010) reported that increasing utility bills were by far the biggest concern among Australian consumers[3] and these cost concerns were certainly reflected in Australian Bureau of Statistics (ABS) data. The latest quarterly statistics report that while inflation rose 2.7 per cent in 2010, electricity rose 12.5 per cent, and water and sewerage costs by 12.8 per cent.[4] Recent press headlines flag even higher utility prices in the pipeline.

On top of that, as these items move up in price, they have a greater impact on the CPI when the ABS recalibrates the index every five years. In the latest adjustment, food moved up 1 per cent while utilities including power took up an extra 1.8 per cent of the index.[5]

Electricity price shocks: preventable?

What can consumers do about rising electricity costs? Apart from choosing energy-smart appliances and running fewer of them, it seems that an effective answer might be to switch to solar. For the first time the cost of solar is almost at level pegging with the cost of conventional power. Thanks to government incentives, the falling cost of the technology, the rise in the Australian dollar, and increases in the costs of conventional power, those who switch to solar should be getting free electricity for a decade once the system is paid off over 7–10 years. In fact, those who generate enough solar power to sell the excess back to the supplier grid might even make a profit out of it.[6]

Thankfully, it seems that the proposed carbon tax will not impact heavily on household electricity costs if implemented. Estimates suggest that it could add up to between $2.70 and $4.20 a week to the bill, but that should be offset by compensation promised to low and middle-income earners.[7]

1 www.immigration2australia.com/living_in_australia/living_cost_of_living/
2 ABS Media Release, 27 Apr. 11. Plus commentary and analysis, JB Were (Tim Toohey), 27 Apr. 11
3 Nielsen Global Online Consumer Survey for Quarter 2, 2010
4 http://www.dailytelegraph.com.au/money/money-matters/prices-go-up-the-cost-of-living-at-a-glance/story-fn300aev-1225859344076
5 http://www.theaustralian.com.au/business/industry-sectors/food-power-add-weight-to-cpi/, March 23, 2011
6 http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/6401.0Main%20Features3Dec%202010?opendocument&tabname=Summary&prodno=6401.0&issue=Dec%202010&num=&view=
7 Abbott's beef on carbon tax doesn't add up, Lenore Taylor, SMH, April 9, 2001

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The costs of living continued

Driving off the road?

With turmoil in the Middle East, petrol prices increased by 9.1 per cent last year[8] and indications are that this trend may continue. Similar price pressures in the US, the home of the motor vehicle, have seen an increase in sales of fuel-efficient vehicles, a drop in the number of miles being driven, and a fall in discretionary spending.[9]

More than 65 per cent of Australians already use public transport to get to work but other alternatives are being embraced. The number of adults riding two wheels to work pushed bike sales to 1.3 million in 2010[10] and two other options, car sharing and car pooling, are growing fast. Car sharing, mainly in inner city areas, gives people access to a car on an hourly basis, while car pooling makes it easier for those living further out to share rides and reduce costs.[11]

Mortgage rates – the great unknown

J. P. Morgan challenged the Reserve Bank's annual CPI figure of 2.7 per cent for the year to September 2010, claiming that the actual rate was closer to 4.6 per cent, mainly as a result of 2010 increases in bank mortgage rates which rose 32 per cent in that period.[12] Will Australia's 95 per cent employment rate and our rising dollar persuade the RBA to increase the official rate sooner rather than later? And how will the banks react to that? Only time will tell.

Could this be you in 2021?

One interesting fact about Australia is that in spite of all the talk about a two speed economy, our prosperity does not seem to depend on where we live. A recent study by Bankwest reported that the two 'boom states', Western Australia and Queensland, had the highest percentage of Australians in financial difficulty.[13]

Despite where you live in Australia, if the present trends continue, you may well find yourself in a decade's time living in a solar powered house and driving a shared car. Hopefully, you will still be living in one of the world's strongest economies; life might be quite different, but just as good.

If you want to discuss how you might adjust to these changes and their impacts on your financial priorities please don't hesitate to call.

8 http://www.dailytelegraph.com.au/money/money-matters/prices-go-up-the-cost-of-living-at-a-glance/story-fn300aev-1225859344076
9 Gas Prices Rise, and Economists Seek Tipping Point, by Christine Hauser. NYT 11 Apr 2011. http://www.nytimes.com/2011/04/12/business/12fuel.html?_r=1&emc=eta1
10 ABS data
11 Pooling for the future, Denise Cullen, The Age, May 30, 2007
12 The true cost of living in dispute – Chris Zappone SMH February 8, 2011 http://www.smh.com.au/business/the-true-cost-of-living-in-dispute-20110208-1akjs.html
13 Bankwest The Financial Fitness Index 2011

Insurance for the self employed

Most self-employed people accept the need to protect their income in the event of sickness or injury with income protection insurance. However, an equally important type of risk insurance is available, but is widely undersold and misunderstood – business expenses insurance.

What is business expenses insurance?

Business expenses insurance provides a monthly benefit to cover the ongoing fixed expenses when a business owner can't work due to sickness or injury. Like income protection insurance, the premiums are tax deducible.

Who is eligible?

Business expenses insurance is designed to assist self-employed individuals, including sole traders and business partnerships (typically this can include up to 5 partners) who generate income through personal exertion.

What is covered?

Eligible expenses for this type of insurance must be ongoing, and may include items such as:

- office rent
- interest payments on a business loan
- salaries of non-income generating staff
- leasing of equipment such as cars, telephones
- insurance and legal fees, and
- property rates and taxes.

How much cover would be required?

An important factor to consider when calculating the required monthly benefit is to determine what would happen to the revenue of the business if the person to be insured was unable to work for a period of time.

A sole trader for example, would need to insure 100 per cent of their fixed ongoing expenses. However, an individual working in a partnership may only need to insure 50 per cent of expenses (or the amount they are responsible for).

How is a business expenses insurance claim paid?

When submitting a claim for business expenses, proof of the fixed expenses will be required. A copy of an accountant's report, profit and loss statements and BAS statements are commonly submitted for

consideration. The benefit period is generally 12 months but some companies allow an additional 6 to 12 months of benefit payments if the expenses at claim time are less than the actual insured monthly benefit.

Is business expenses a 'set and forget' policy?

Business expenses policies should be reviewed on a regular basis – yearly or whenever a change occurs in a business. Because business expenses are likely to fluctuate on an annual basis it's important to review your cover to ensure the benefit amount is right for you.

Retire your debt, or retire with debt?

More and more Australians are carrying debt into retirement. So is it a good or a bad thing?

According to the Financial Stability Review which the Reserve Bank (RBA) released early in 2011, increases in debt owed by households aged 55 and over accounted for almost two-thirds of the increase in aggregate debt in 2008/09, even though the over 55s make up only one fifth of all households with mortgages.[1]

This group outstripped the younger households on two fronts: a greater share of households with debt, and stronger growth in their average loan balance.

The RBA says this suggests that a greater number of households are carrying debt as they approach the traditional early retirement age than was the case a few years ago.

There are a number of contributing factors. The RBA cites less downsizing by older households, larger mortgages which take more time to repay, increased use of reverse mortgages, and people working longer.

The downturn in downsizing might well be attributed to children living at home longer, while divorce also derails many a retirement plan.

All this begs the question: should you strive to pay off your debt at or before retirement, or is there any harm carrying it into retirement?

Planning ahead

Whether you are retired or not, being debt-free is generally the preferred option, and planning ahead should go some way to making this a reality. As with all things financial, it comes down to budgeting for the present and planning for the future. The sooner you plan, the greater your chances of achieving a debt-free retirement.

Budgeting will help you work out whether you are living beyond your means. It's worth noting that just like compound interest can improve your financial wellbeing, compound debt can destroy it, making debt-free retirement almost an impossible dream.

Step one is to pay off debt that's not tax-deductable, especially borrowings on depreciating assets like cars. First to go should always be your credit card debt, as that is likely to carry the highest rate of interest.

Your home loan is also non-deductible debt but hopefully it isn't a depreciating asset.

You might want to consolidate all your outstanding debt into a lower interest rate like a mortgage, but you need to make sure that years later you're not still paying off that holiday you took in 2011!

Good debt is that which is used to generate income – such as buying an investment property, managed funds or a share portfolio – but this may prove less effective once you are in retirement.

One form of borrowing used to generate income is negative gearing, and it is best suited for those who are still working full time. As a retired couple in 2010-11 can have their tax-free super pension and earn up to $53,360 before paying additional tax, then it's unlikely there would be much benefit from negative gearing in retirement.

A super way to clear debt

To minimise or eliminate your debt level in retirement, you can use your superannuation as part of your strategy.

You may even deliberately choose this path because there is a sound argument for salary sacrificing into super prior to retirement, as an alternative to paying off your mortgage. You can then use your tax-free super money – once you have retired and are beyond the age of 60 – to pay off your mortgage.

The strategy involves putting money into your super up to your concessional cap – $50,000 if you are over 50; $25,000 if you are under 50 – as you only pay 15 per cent tax on that money rather than your marginal rate.[2] That way, every $100 contributed to your super before tax will give you $85 to invest for your retirement. Once you retire and turn 60 then you can pay off any remaining mortgage balance using tax-free money from your super. And along the way you'll have also built up your retirement savings.

By holding back on your mortgage payments, you've created more chances to build up your retirement savings. Then once you retire and turn 60 you can pay off any remaining mortgage balance using tax free money from your super.

By contrast, if you pay off your mortgage while you are still working you are using your after-tax income. So for every $100 you earn you may only have as little as $53.50 to clear your home loan should you be on the top tax rate.

The price of debt

Debt has a price, and that price is the interest you pay on it. If your risk profile is conservative then you are probably better off clearing your debt as the income you earn on your investments will often be less than what you would pay in interest on the loan.

If you are a more aggressive investor then there may be some argument to carry the loan forward but in an ideal world, plan to be debt free in retirement so you can really enjoy the good things in life.

1 http://www.rba.gov.au/publications/fsr/2011/mar/html/contents.html

2 These concessional caps are correct for the 2010-11 and 2011-12 financial years. However, they are subject to change from 1 July 2012.

Review or regret – why reviewing your wealth protection plan is a solid investment

A wealth protection strategy is an important part of any overall wealth creation plan. Of course, we're all interested in reviewing the current status of our wealth creation plan to see how our investments are performing.

But, reviewing your wealth protection plan is an often forgotten activity, as many of us adopt a 'set and forget' approach to insurance. Payment of insurance premiums is often viewed as a necessary evil, and few clients contact their adviser to facilitate a review.

When should a review occur?

A review of your risk insurance should be conducted whenever there is a change in your personal or business circumstances.

Changes in any of the following areas should prompt you to review your cover as they can impact the type and amount of insurance cover you need:

- income
- debt levels
- dependants
- relationship status (marriage, divorce, new partner)
- occupation/employment status (i.e. self employed or employee)
- health (improvements or change in health of you or your partner).

Typically, a review of your wealth protection plan is instigated by your financial adviser. They may contact you on an annual basis to determine any relevant changes to your situation and recommend a review of your insurance cover and amount.

What if nothing has really changed?

Even if nothing has changed, it's still worth reviewing your risk needs, at least on an annual basis to make sure you still have the most appropriate products to suit your needs. Intense competition in the risk insurance industry means that insurance providers are always looking for the 'edge' with their products, particularly to ensure they remain in the top quartile of rated products. This results in ongoing product improvements, in the form of additional benefits, better policy definitions and the introduction of new additional options.

While many insurers will automatically 'pass back' any improvements in policy definitions to a client, this shouldn't be assumed. A regular review will ensure that your policy provides you with the most appropriate benefits and features to meet your needs and objectives. By keeping your policies up to date with changes in the industry, you may have a better outcome should you need to claim.

The following story[1] highlights the importance of making the time to review your risk insurance.

Joanne and Michael's story

As the mother of two children, Joanne didn't need to be reminded of the importance of holding adequate risk insurance to make sure her family would be looked after in the event of suffering a serious illness or injury or premature death. Both Joanne and her husband Michael met with their financial adviser when their first child was born 8 years ago and with her assistance implemented a wealth protection plan to cover their family.

As Michael was the family's income earner he met with their adviser on an annual basis to check his income protection benefit was adequate and confirm the family's debt levels hadn't changed.

Joanne was busy looking after the family and despite the adviser's recommendations to revisit her insurance, at least on an annual basis, she kept putting a review off until she had more time.

Sadly, several months ago, Joanne was diagnosed with carcinoma in situ of the breast, an early form of breast cancer that has a good prognosis if found early and treated. Joanne underwent removal of the breast lump and a course of chemotherapy over several months. Fortunately, Joanne's doctor has given her a good prognosis.

Once Joanne's treatment had finished, Michael contacted his adviser to find out the necessary steps to lodge a trauma insurance claim for Joanne.

Joanne's insurance cover hadn't been reviewed for eight years and her policy definition of cancer did not provide a payment for the treatment she received. She was not eligible to receive any benefit from her trauma policy.

Michael had taken time off work to mind the children and support Joanne through her treatment. While he had some leave entitlements, he still needed to take unpaid leave. There were also medical expenses that were not covered by Medicare or private health insurance. These costs would now have to be borne by the family.

Had Joanne undertaken a review of her insurance cover, she may have considered upgrading her trauma insurance to a new policy that would have paid a partial benefit for her breast cancer.

1 This is a true story. Some details have been changed for privacy reasons.