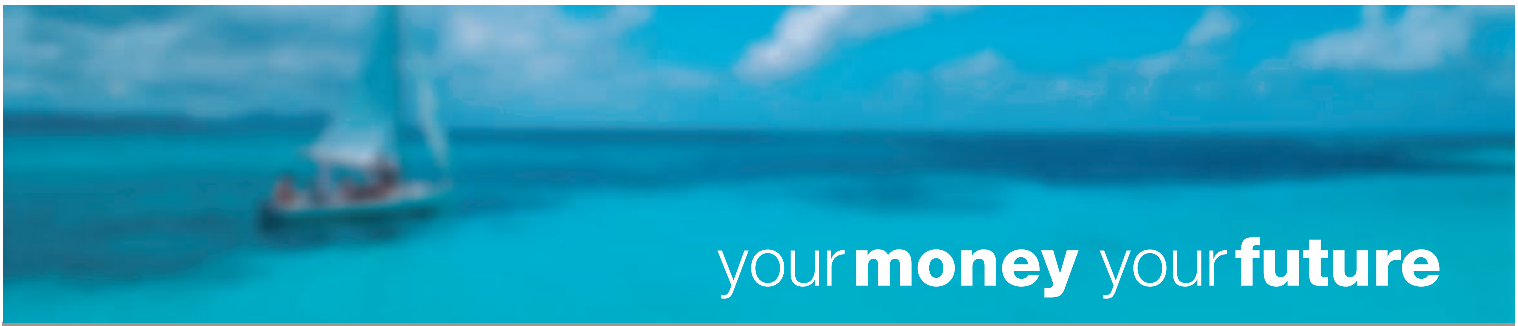

FINANCIAL PLANNING NEWSLETTER

Parity: but what now?

When the Australian dollar reached parity with the US dollar there was jubilation among some in the media, as if we had won a hard-run race.

Had we? And, if so, where's the prize? Why should we have this sense that we have achieved some holy grail?

The Australian dollar breached parity three times in as many months late in 2010; by New Year it was commonplace. The reasons vary: weakening currencies in the major economies of the US, Europe and Japan; strong commodity prices on the back of demand from Asia, and particularly China; the widening interest rate gap between Australia and other countries whose currencies are also traded frequently.

It's hard for overseas investors not to want to invest in fixed interest here when our rates are around the 6 per cent mark. Offshore rates are significantly lower. While our official rate is 4.75 per cent, the official rates of the US, Europe and Japan are all below 1 per cent.

Monetary easing in the US has kept the greenback under the hammer. The US Federal Reserve introduced its second quantitative easing program (named QE2 but bearing little resemblance to a luxury cruise). This has seen a flood of money onto the US market in a bid to stimulate the economy but there are plenty of doubters who believe it won't work the second time around. Printing money to stimulate national economies has a bleak history.

Another factor bolstering the Australian dollar is that we have displayed solid economic fundamentals, being the only OECD country to come through the 2008/09 crisis without going into recession.

Rebalancing world currencies

Some see the strength in the Aussie currency as merely a rebalancing of world currencies between those countries with high levels of consumption and/or private debt, and those with low debt.

Whatever the reasons, the strong Aussie dollar gives us the opportunity for cheaper travel overseas and to enjoy cheaper electronic equipment, flat screen TVs and cars. Lower prices constrain inflation, which should also help to limit any future interest rate rises as it will keep annual consumer price index (CPI) increases within the Reserve Bank's preferred 2 to 3 per cent range.

Other winners from a high dollar are those businesses reliant on imported materials as they can enjoy the benefits of lower input costs, and industries such as agriculture or mining which require imported machinery.

But can the strength last? Having broken through the $US1 mark, will our dollar drop back? The balance of opinion seems to favour the dollar being around

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Parity: But what now? continued

parity through 2011 – some even think as high as $US1.10 due to the strength of demand for our resources.

Of course it's not good news for everybody. Exporters in particular can feel the chill from the strong currency. One area hurting is tourism; another is higher education with a drop in the number of overseas students wanting to study in Australia, undermining an export industry which earned $18 billion in 2009.

Should you hedge?

To 'hedge' is to take steps to insure against loss. Some resource companies hedge against currency fluctuations, others don't: Rio Tinto hedges, BHP doesn't.

Because the Australian share market represents less than 3% of the world share market (MSCI), many investors seek exposure to iconic international businesses like Microsoft, Toyota or Apple. In doing so, these investors may feel some pain from a strong dollar and wonder if they need to hedge.

If your money is invested overseas there will inevitably be currency risk. Indeed, if the Aussie dollar were to rise enough, any positive returns could well turn south.

Let's take a simple example in Aussie dollars to illustrate the point. Say you had $10,000 invested in US assets with a return after fees of 6 per cent and the dollar was at parity. Your return would be $600. But if the Aussie dollar rose to US$1.05 then the value of your $10,000 capital investment would fall to $9,524 and your $600 becomes $571. So instead of having $10,600, your principal and return is only worth $10,095. Conversely, if the dollar were to fall it would magnify your gain.

There is no right or wrong when determining if it is appropriate to hedge international investments. There is a small cost involved as with any form of insurance. If you don't hedge, swings and roundabouts will inevitably influence the return in the short term but over time the currency impact on your total return will generally even out.

Parity may well be here to stay for at least the short to medium term but as in all races there are winners and losers. If you need any advice on your international investments please don't hesitate to contact our office to discuss your needs.

Power of Attorney – taking the first step

Giving your power of attorney to someone is a major step. It means giving them the right to make financial and other decisions for you if you are not able to do so.

While their names and specific rules vary among the Australian states, there are four different types of power of attorney.

General: gives your financial decision-making powers to someone else until a specific date. It lapses on that date or if you become incapable of making your own decisions.

Enduring: gives another person (or persons) the power to make your financial and legal decisions, and continues to apply even when you are no longer capable of decision making.

Enduring Medical: appoints a person or persons to make decisions regarding your medical treatment on your behalf if you are not capable of doing so. (This is not a 'Living Will', which is a document recording your express wishes regarding resuscitation and other important medical decisions).

Guardianship: empowers someone to act for you in all areas of your life should you be incapable of making decisions. It is not strictly a power of attorney but it works like one.

To sign over power of attorney you must be capable of appointing someone and understand the implications of your action.

But what happens if you haven't signed a power of attorney and an accident or medical condition removes your option?

In that case, a statutory official – a Public Advocate or Guardian – appoints a guardian for you. The appointee may or may not be a family member or close friend, and as a result, decisions regarding your life and finances could possibly be left to the Public Trustee.

Most states also have a body which can review enduring powers of attorney, remove an attorney, or substitute one if the original person is no longer able to fulfil that role; or require the attorney to provide accounts or submit a financial management plan.

You can buy or download a standard Power of Attorney form, but if your financial affairs are complex or cross state borders, or you have estate planning issues, you should discuss the details with your financial adviser who may recommend that you also need legal advice.

Take action now, because by the time you need it, it may be too late.

Borrowing within an SMSF to purchase property

The financial press has given much recent coverage to a 'new' option for wealth creation – establishing a self-managed superannuation fund (SMSF) and borrowing to invest in direct property.

Before jumping ahead and setting up an SMSF to buy an investment property, you must be aware this area involves complex legislation and rules, and specific financial advice (along with accounting and legal advice), is required to ensure a successfully implemented strategy.

The attraction

Common impediments facing people wishing to build a direct property portfolio include accessing a deposit[1], the ability to generate surplus monthly cash flow (for negatively geared property), and the ability to borrow from a bank.

Using an SMSF can overcome these problems. In fact, subject to the trust deed and investment strategy of the fund, there are no restrictions on which asset class the funds can be invested in. An SMSF can also borrow to leverage the investment, provided the loan is a limited recourse loan for investment purposes, through a trust[2], as explained below.

How does borrowing to purchase property in your SMSF actually work?

The favoured trust for a limited recourse loan is an instalment trust. An instalment trust allows the SMSF to purchase a property, repaying the limited recourse loan by instalment, while the asset is held in the trust which is separate from the SMSF for the life of the loan. If the SMSF defaults on the loan, then the lender's rights are limited to the property in the trust only, while the fund's loss is limited to the equity in the property and all instalment payments made prior to the default.[3]

What types of property can your SMSF purchase?

Residential

SMSFs are able to purchase any residential property at public auction or a private sale, provided it is not purchased from a related party. It cannot be transferred in specie into an SMSF from related-party ownership.

The purchase of direct property must be for investment purposes only and you cannot receive any other benefit from it, so buying a holiday house with your SMSF for you or your family is strictly prohibited.

Business real property

The rules for business real property are different to that of residential property. Business real property includes commercial properties, offices, warehouses and farms. Like residential property it can be bought at auction or private sale. However, unlike residential property, it can be transferred in specie into an SMSF by related parties at market value. Business owners are also able to buy their commercial premises, and pay arm's length rental to their SMSF.

There are taxation benefits from owning business real property within an SMSF, particularly if that property was initially owned outside of superannuation, and/or you are a business owner. Each individual case must be assessed on its merits of course, and key rules still must be adhered to including contribution limits and the work test, as well as taking account of capital gains tax implications.

Appropriate diversification

Depending on the total funds available within your SMSF, your ability to diversify with direct property may be limited. Lack of diversification can increase the risk to your retirement plans if your property investment doesn't perform in line with expectations. It is important to remember even 'blue chip' property prices can lose value. Property values in the USA, UK and Ireland have all decreased by varying degrees over 2008–2010, reminding us that past performance in any market, including property, may not repeat itself in the future. The lesson is... be careful.

Is it right for you now, or in the future?

While members of an SMSF are working to accumulate funds, assets that produce little income for the SMSF may not present any immediate problems. However, in retirement, income (and therefore liquidity), is of paramount importance when specified withdrawal amounts of income are required by law. For example, an 80-year-old member must withdraw 7 per cent of their SMSF capital each year, rising to 9 per cent from age 85.[4]

A significant concern with residential property is that it often produces less than a 5 per cent net rental yield (after expenses)[5] and consequently insufficient retirement income. Because property is not divisible and can't be sold off 'bit by bit', unlike units in a managed fund, accessing liquid funds often results in a forced sale.

Next steps

When buying property through an SMSF you should always consider the quality of the investment with a clear understanding of the associated risks. An objective approach rather than decisions based on emotion will always serve you best in the long run.

Please feel free to contact us to discuss whether this strategy is appropriate for you.

1 Generally, a 20% deposit is required to avoid mortgage insurance.

2 The trust deed of the SMSF must allow the trustee to borrow before any limited recourse borrowing arrangement can be entered into.

3 Source: Adviser Tech: SMSF/Borrowing within SMSF Technical Bulletin.

4 www.ato.gov.au (NB: this amount represents the amount prior to the temporary halving of income stream minimums post GFC to give relief to members wishing to preserve their balances). In the long term, minimum percentage investors should consider with respect to yearly liquidity requirements for their SMSF.

5 www.rpdata.com/press_releases/australia

Two sides of the coin

Europe is still caught in the financial crises that swept major economies in 2008/09. It suffered a banking crisis and then a debt crisis, accompanied by a fall in the value of the euro. And, according to some commentators, there is still more pain to come in 2011.[1]

A lower Euro means Australians can travel more cheaply to see the treasures of Europe, but Europeans need to dig much deeper to enjoy our sport, beaches and the outback. But does this crisis in Europe matter to Australia while our economy powers along, spurred by resource demands from Asia?

Europe – the issues

What started with a banking crisis for countries like England, Germany and France has shifted focus to the high debt levels of some of the smaller, traditionally weaker European Union economies. The unflattering tag 'P.I.G.S.' has been applied to Portugal, Ireland, Greece and Spain, though others could easily sit alongside them. Greece and Ireland have had much-publicised bailouts, and all four countries are trying to implement budget cuts to satisfy the International Monetary Fund (IMF), European central banks, credit rating agencies and the investors who buy government bonds.

When major investors become worried about the ability of governments to repay debt it can start a vicious cycle: yield on government bonds is forced up to attract investors; restructuring and austerity measures are introduced; the economy slows or goes into recession; government income drops and it can't pay its debts without another bailout...

In 2009 Iceland hit the wall in a financial crisis worse than Ireland's but it was able to respond in a number of ways: obtain an IMF loan; stop the flow of money out of the country; devalue the krona; and allow foreign lenders to 'take a haircut'. Two years later, investors now price its debt lower than Ireland's, showing recovery is already on the way.

There may be only one letter difference between 'Iceland' and 'Ireland' but their recovery options are miles apart because Ireland is in the European Union, and also in the Euro zone. It cannot devalue its currency or control money flows; plus, it decided to guarantee the money in Irish banks, pushing heavy losses onto Irish taxpayers rather than international

investors. When you add rising unemployment and steep falls in property values, the local economy is hit hard. Recovery is likely to be painfully slow.

Euro – help or hindrance?

The Euro is just 12 years old, coming into circulation in 11 countries on 1 January 1999. Twelve years later it is still growing, with Estonia joining as the 17th member on 1 January 2011; plus, it is used in five other European countries. While this is good news, Estonia is the poorest of the countries in the Union, illustrating again the problem that Europe faces with a single currency across widely divergent economies, from powerful Germany to the weakened P.I.G.S.[2]

What does it mean for Australia?

There is a lot at stake for Australia as well as Europe. As the Governor of the RBA, Glenn Stevens, has pointed out, "The United States and Europe – along with New Zealand... continue to account for a large proportion of Australian investment abroad and are the source of the vast bulk of foreign investment into Australia."

Australia's Merchandise Exports by Destination

Per cent share of total, financial years

Destination	1999/2000	2009/2010
China	5.1	23.2
Japan	19.3	18.5
South Korea	7.8	8.2
India	1.6	8.1
Euro area + UK	**12.0**	**7.6**
United States	9.9	4.8
New Zealand	6.9	4.0

Sources: ABS; RBA

Europe–Australia trade is still strong, and will become more vital if and when the heat comes out of our trade with the booming Asian economies. As the table shows, recent figures published by the RBA show that Australian exports to Europe (Euro area and UK), have dropped in the past ten years but remain at 7.6 per cent, which is above the US and on par with India. The value of our exports to the European Union is dominated by gold and coal, while our imports centre on medical supplies and vehicles.[3]

The bottom line is that Europe is still important for Australia and Australian investors, not just as the source of our political and social infrastructure but as an important trading bloc.

And it is a great place to holiday, especially while we get such good value for our Aussie dollars.

Sources

1 Simon Johnson "Fresh crises loom in Europe and the US", NYT, 30 December 2010.

2 Estonia enter a new era with Euro adoption, NYT, 31 December 2010.

3 'European Union', DFAT Fact Sheets.