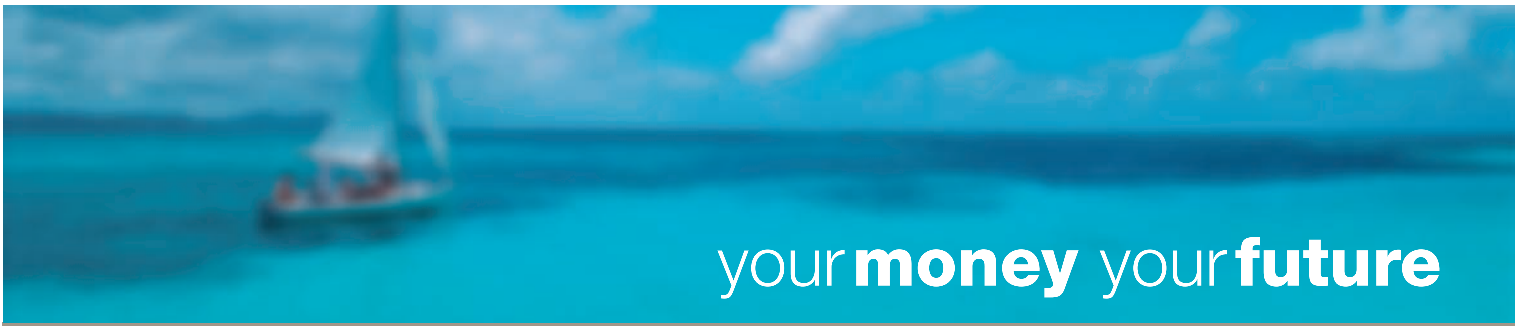

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FINANCIAL PLANNING NEWSLETTER

Demystifying risk

The term 'risk tolerance' is at the centre of things when it comes to making investment decisions. But what does the term really mean? Is it possible to pin it down so we understand it better, and understand the role it plays in our investment decisions?

Researchers into human behaviour and finance like David R Hunter have taken a closer look.[1] One way we can share their insights is to put down a few statements about risk – some might call them 'myths' – and then look more closely at each statement so we can understand what the research really shows.[2]

My risk tolerance is high in the good times. But when the markets drop back, so does my risk tolerance.

In fact, according to Hunter, our risk tolerance does not change; it is our **perception** of risk that changes. He describes risk perception as the rational process we follow in making an assessment, whereas risk tolerance is more of a personality trait.

We might agree that a Formula One driver like Mark Webber has a high risk tolerance for speed. If he drives at 270 km/hr in the straight but drops back to 90 km/hr to take a bend, does that mean his risk tolerance is higher in the straight than it is on a bend? No, his risk tolerance is constant, but his perception of the amount of risk changes; that's why he reduces speed.

My risk tolerance determines how I allocate my assets. And ultimately it determines whether I'll meet my investment objectives.

To sort out the relationship between risk and asset allocation, Hunter says it helps to take a closer look at three components of risk.

Risk **required** is the first of these. This is a financial characteristic which describes the risk you need to take on to achieve your financial goals.

Risk **capacity** is also a financial characteristic, describing the flexibility built into a financial plan. Put another way, it's about the answer to this question: How much downside can you cope with before your plans are off track?

Finally, there is risk **tolerance**. This personality trait describes the level of risk an investor prefers to take.

Asset allocation depends on all three of these risk components. The task for the investor, with their financial adviser's guidance, is to find the right balance.

I love bungee jumping and abseiling from skyscrapers; therefore I exhibit a high risk tolerance in my investment decisions.

No, this is not what the research shows, according to Hunter. He says there are four types of risk tolerance – physical, social, ethical and financial. In practice, we all behave consistently **within** a risk

1 David R Hunter, 'Risk Perception and Risk Tolerance in Aircraft Pilots', http://www.equinox.co.za/article_2771.html

2 Hunter, ibid

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charter financial planning

Europe's sovereign debt – a king size headache?

Some think that sovereign debt – in simple terms, borrowings by a national government against securities issued by the Treasury of the same government – can be the world's riskiest form of lending.

The reason? There is no security or collateral for these loans beyond the financial stability of the borrower, expressed as their international credit rating. If Country A were to default, for example, then the lenders (Country B; Bank C), can't lay claim to a city or a few suburbs to get their money back; they just take their losses. But Country A will struggle for years to get another loan at reasonable interest rates.

Some smaller economies in Europe, notably Portugal, Ireland and Greece, have been unable to service their sovereign debt. Greece has been targeted as the worst offender, having gone to the brink twice since January 2010, before being rescued by French and German financing each time. But problems remain and a third bailout package may be needed. While this drama unfolds, there are fears that Italy and Portugal are on the same path.[1]

Australia has been largely unaffected by this European angst to date. Our government has no exposure to European sovereign debt and our commercial banks, which at one stage were relying heavily on wholesale borrowing from European banks to finance their domestic lending, are no longer widely exposed to a deteriorating European lending climate. So why did treasurer Wayne Swan warn us that the Greek financial crisis could result in global turmoil which could involve Australia?

A real threat?

The reason is that, in a worst-case scenario, the European sovereign debt crisis could escalate and spread across the Atlantic to the USA. At the moment, American banks have approximately $41 billion of direct exposure to Greek debt, plus problems with their own national debt levels.[2]

This combination of US and European uncertainty could ultimately lead to in bank failures reminiscent of the Lehmans collapse which, some argue, triggered the Global Financial Crisis.[3]

The only way for the weaker members of the European community to remain solvent and honour their obligations to repay their sovereign debt is to obtain further financial aid from the stronger members of the group. The problem is that both France and Germany have already committed billions of Euro to Greece, and French and German taxpayers are objecting to any further aid. Plus, the interest rates on new emergency loans will be so high it's feared Greece will never be able to repay the debt.[4] France and Germany, with the European Central Bank, are urgently seeking a viable solution. A recent proposal is that Greece be allowed to default on part of its debt, resulting in losses to the bond holders, but a smaller and more manageable national debt.[5]

Building a solution

Though some lenders might have to take a slight 'haircut' after a partial default, it might be a better outcome for the European banks than the far more drastic alternative. This 'alternative' is simply that Greece defaults on its sovereign debt. This would mean all its debts would be written off or discounted, which did happen in Argentina in 2001.[6] This proposal may have some appeal to many angry Greek citizens who took to the streets in protest against the austerity measures announced to qualify for the last European handout. Not surprisingly, a default on this scale has far-reaching implications. While Argentina ended its sovereign debt crisis by defaulting, to this day it can't borrow money overseas.[7] On the flip side, their economy took just three years to recover.

A further complication for Europe is that a cashed-up China is standing by to pick up some pieces. China recently acquired Greece's largest container terminal in Pireus at a bargain price, gaining an important entree into the European shipping market. It is now looking for more bargains.[8]

Within Europe, France and Germany have the strongest incentive to continue supporting the weaker economies in the euro zone – particularly as the amounts of money involved may look huge but are not that large in relative terms.[9] Greece represents only 3 per cent of Europe's gross domestic product (approximately $311 billion vs. $16 trillion) and currently owes France the equivalent of 34 per cent of its GDP and Germany 21 per cent.[10] Given this relativity, France and Germany will hopefully once again pull a rabbit out of the euro hat to protect the currency and the European trading zone.

If that happens, we can echo federal treasurer Swan's statement of June 2011: "There's no doubt there are great challenges in Europe and there's no doubt there were great challenges in Europe this time last year … but fortunately we're in the right part of the world at the right time. The Asia-Pacific is relatively strong, our economy is strong."[11]

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3 News Ltd Greek mess may cause second GFC http://www.news.com.au/money/david-and-libby-koch/its-a-big-fat-greek-mess/story-fn7kicty-1226082521170

4 EU leaders differ over Greek default, Financial Times, July 8, 2011 http://www.ft.com/cms/s/0/5c05b8de-a994-11e0-a04a-00144feabdc0.html#ixzz1Rf0BnyEw

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6 The Guardian, July 10 2011: Defaulting rescued Argentina. It could work for Athens too, http://www.guardian.co.uk/business/2011/jul/10/european-debt-crisis-argentina-imf

7 Easybourse , 18 April 2011, "Euro zone crisis escalates on Greek debt fears" ttp://callback.easybourse.com/bis/default.asp?c=&p=o1_ap_eb_banniere zone 2011 Copyright © 2011 Reuters

8 BBC News, Greece 25 june 2011-07-09, www.bbc.co.uk/2/hi/programmes/from_our_own.../9520732.stm

9 NY Times, April 5 2010 – As Greek Bond Rates Soar, Bankruptcy Looms, http://dealbook.nytimes.com/2010/04/09/as-greek-bond-rates-soar-bankruptcy-looms/

10 Why Greece Sovereign Debt matters to Australia. July 2011. http://www.theotherschoolofeconomics.org/?p=984

11 Perth Now. June 27, 2011, "Australia well placed economically, says Treasurer Wayne Swan" From: AAP

Coming to grips with carbon emissions

Like the GST before it, the introduction of a carbon tax from 1 July 2012 now seems inevitable. So, if you're going to have to pay it, how can you live with it successfully, and possibly profit from it?

Impact on our pockets

The overseas models are reassuring. Carbon taxes are well established in many countries including Denmark, Sweden, the UK and the Netherlands. Each of these countries has packaged its carbon emissions regime with its own balance of charges, rebates, trade-offs and offsets, making it difficult to compare the outcomes. A 2010 survey reported that the introduction of the carbon tax had had negligible impact on the economies of the European countries which introduced it between 1994 and 2004[1]. More recently, a May 2011 report commissioned by General Electric concluded that it is possible for economies to reduce carbon emissions while maintaining economic growth.[2]

Even though motor fuel is exempt and the government has announced compensation for 70 per cent of households, the tax will affect some individual tax payers as prices rise, depending on what they consume, and how much of it. Household compensation is designed to meet predicted cost of living increases flowing from the tax of an estimated $10 per family per week at the supermarket checkout.[3]

However, it seems that the tax will have minimal impact on the investment strategies of those saving for superannuation and approaching retirement. The Investor Group On Climate Change, which includes the chief executives of Australia's largest superannuation funds have rebuffed criticism that a carbon tax would leave them unable to compete with overseas rivals and they predict it will have little negative effect on their performance.[4]

Impact in our economy

There is no doubt that the new carbon tax will impact on the economy, even though diesel and petrol are not affected, and Australian export industries such as the steel industry will be compensated to ensure that their pricing remains competitive in overseas markets. The new tax will be paid by the 500 heaviest producers and consumers of emissions produced by burning carbon fuels, including every coal-based electricity generator, and this extra cost will inevitably be passed on to end users. As a result, most businesses will be exposed to it in the form of higher energy bills, or pay it as part of the price of products and components manufactured using carbon-based energy.

This, of course, is the central point of the tax – commercial energy producers and users, obliged to factor the tax into their business plans, will adopt strategies to minimise environmental impacts, thus reducing both their carbon tax liability and greenhouse emissions. The new tax should stimulate industry to seek cost-effective replacements for carbon energy or less carbon-hungry power sources. This pressure on industry to cut carbon use will only increase, since the tax rate will be increased annually to achieve greenhouse reduction targets.

New opportunities

Non carbon-based power sources such as solar energy and wind farms, environmentally advantaged power generation from sources like landfill gas, and new technology such as improved solar energy panels, should become sought-after investment prospects in the near future. Airlines, for example, are planning to partly replace crude oil as a source of aviation fuel, with Virgin investing in technology to convert eucalyptus oil into aviation fuel, while Qantas is investigating production of aviation fuel from green waste and garbage.

Companies which effectively cut their expenditure on carbon tax permits or introduce lower carbon technologies will attract the attention of venture capitalists, shareholders and fund managers. For many, the real financial incentive will come with the promised transition to emission trading in 2015. Emission trading schemes are already in place in 32 countries and converting carbon emissions to a tradeable commodity in Australia could transform energy credits earned through carbon efficiency into a viable exportable product.

Australia's carbon future: The ins and outs[5]

- Starts on 1 July 2012, at a rate of $23 per tonne, rising annually by 2.5 per cent in real terms. Transition to an emissions trading scheme from July 1, 2015 means that the market then sets the price.
- Affects around 500 companies, the largest producers of carbon emissions. They pay the tax and will pass costs on to their business customers.
- Compensates around 70 per cent of households fully for cost of living increases; a further 20 per cent of households are partly compensated.
- Imposes no new tax on household and commercial diesel fuel and petrol.
- Gives assistance to conventional electricity generators to convert to cleaner technologies.
- Introduces a new $1.2 billion Clean Technology Program to improve energy efficiency in manufacturing and support research into low pollution technologies.
- Assists emissions-intensive businesses with a $9.4 billion program, to offset exposure to competition from countries without a comparable carbon price.

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2 http://www.ge.com/au/protectingprosperity/
3 SMH, July 11, 2011
4 IGCC: http://www.igcc.org.au/Resources/Documents/Global%20Investor%20Report%20embargoed%20to%20June%2013th.pdf
5 Australia's carbon tax details on tap, Marketwatch, July 8 2011. http://www.marketwatch.com/story/australias-carbon-tax-details-on-tap-2011-07-08?reflink=MW_news_stmp AFR, Monday, 11 Jul 2011, p 8.

News bites

Retiree cost of living increases

Due to the ongoing rise in the cost of living, retiree incomes need to gain an extra $600 a year for comfortable living.

The Association of Superannuation Funds of Australia has published a report showing that living costs during retirement increased by 1.3 per cent in the March quarter 2011 from the December quarter 2010.

The largest increase in prices was recorded in Melbourne followed by Sydney and Adelaide. A significant factor to the increase was in the rise of the price of fruit at 14.5 per cent, the price of vegetables rose by 16.0 per cent, and with transportation there was an increase of 2.7 per cent and 8.8 per cent in petrol prices.

To achieve a comfortable lifestyle in retirement, speak to us to ensure that you are on track with your retirement plans.

The Flood Levy – know the rules

The Government has introduced a temporary flood and cyclone reconstruction levy otherwise known as the flood levy to provide additional funding to rebuild essential infrastructure. The levy has been created to help affected communities recover from the floods earlier in 2011.

Individual tax payers who have a taxable income of more than $50,000 in the 2011/12 financial year will have to pay the flood levy. For individuals earning salary and wages, the flood levy will automatically be included in the tax taken out of their salary and wages by their employer. For individuals who pay instalments towards their expected tax liability, the flood levy will be automatically included in the instalment rate, for example, self-employed individuals and self-funded retirees.

Exempt individuals are those who have a taxable income of less than $50,000 or fall into an eligible Australian Government Disaster Recovery class.

Individuals entitled to a recovery payment will receive a flood levy exemption declaration form from the Australian Taxation Office (ATO).

Tax rebate for low income earners

The Government recently announced plans for a new measure to help boost the superannuation of lower income earners. If the proposal is approved, individuals earning less than $37,000 would receive a refund on the 15 per cent superannuation contribution tax, to be directed back into their super.

To be eligible for the payment, an individual must have made or received a concessional contribution to their super fund or retirement savings account and have lodged an income tax return for the relevant year. There will be no age test applied, so this measure allows people of all ages to take advantage.

The Government expects it will add some $1.75 billion to super accounts and will assist an estimated 3.5 million Australians.

Planning for your retirement – how to battle the super shortfall and boost your retirement savings

It's official. We are retiring earlier and living longer than ever before.

With the average age of retirement for Australians now at around 62.5 years for men, and around 60 for women,[1] some of us may spend as long in retirement as we did in the workforce.

A longer life expectancy has implications for retirement planning. A 55-year-old woman's life expectancy is now 85.5[2] – that could be over 25 years spent in retirement.

It's therefore not surprising that many people are now rethinking when to retire, and basing their decision not on their age, but on when they can afford to retire to ensure they have enough to live on until the end of their days.

So how much will we need?

As a rough rule of thumb, retirees need about 60 per cent of their pre-retirement income to maintain their lifestyle.

Can you rely on the Government to lend a helping hand? Only up to a point. The basic age pension, at $18,962 (single) or $28,584 (couple) will keep the wolf from the door but is unlikely to cover anything more than the most frugal lifestyle.

Even to buy the basic necessities and enjoy a modest standard of living, a couple needs $31,263 a year. A comfortable lifestyle and involvement in a broad range of leisure activities requires $54,562.[3] That equates to about 12-15 per cent of your gross income for 30 years.

What about employers' compulsory super guarantee payments? Surely they will set you up for retirement, well not exactly. After 30 years on a salary of $50,000, with super guarantee contributions, you will accrue a lump sum of around $183,000 – well below the $500,000 necessary to support a comfortable lifestyle[4].

Another thing to remember is that everything changes, your spending habits will fluctuate during your retirement as you enjoy new hobbies and see more of the world. Your need to access capital will vary depending on expenses such as home renovations and healthcare costs.

And inflation will eat away at your retirement savings. Spiralling costs are a real and present danger for those stuck on fixed incomes. A litre of milk costing $2 today will be $4.85 in 30 years time. A new small-to-medium car costing $27,000 today will set you back $65,536 in 2041.[5]

It's never too late to work out a retirement plan but the earlier you start the easier it will be. Take the first step by arranging an appointment with your financial adviser today.

1 "The Age Pension, superannuation and Australian retirement incomes", Association of Superannuation Funds of Australia (ASFA), Dec 2008.

2 Australian Life Tables 2005-2007, Australian Government Actuary, 2009.

3 ASFA Retirement Standard report, March quarter, 2010.

4 "The Age Pension, superannuation and Australian retirement incomes", ASFA, Dec 2008.

5 Assumes a 3% per annum compound inflation rate.