Personal Wealth

Winter 2012

A Quarterly Newsletter for **Lifespan Clients**

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Back to the Future – European Worries Hit Markets

Recent History

Global equity markets had big rallies in the first quarter of 2012 but have given up much of these gains in April and May. Australia was one of the few countries to record a gain in April and was helped by a low inflation number (1.6% for the year) as well as a 0.5% interest rate cut by the Reserve Bank (RBA) in May.

The European debt crisis is again front and centre with the major concerns being Greece and Spain. Spanish government bond yields are currently over 6%, a level which is regarded as unsustainable. The Greek election result has thrown the bailout into question. It does not appear that a viable government can be formed and we are looking at another election in June. In addition the socialists won the election in France which was a negative for markets. The other concern was the slowing Chinese economy with export growth slowing dramatically.

This heightened risk aversion has resulted in a flight to safe haven assets and led to dramatically lower bond yields. On 10 May the Australian 10 year bond yield hit its lowest level in over 60 years of 3.30% p.a. Yields on 3 year bonds also hit a new low of 2.60%, which is 1.15% below the official cash rate of 3.75% *(Chart 1)

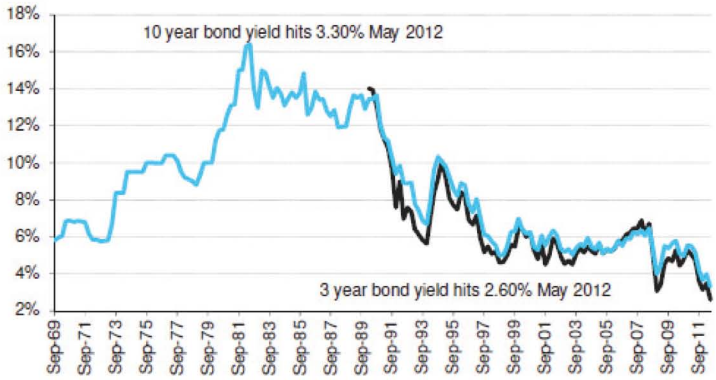


Chart 1. 3 and 10 year Commonwealth Government Bond Yields   Source: Bell Potter

Economy

We are seeing slowing world growth in 2012 although there is still an expectation of a pickup in 2013. Many European countries are in recession (Spain, Greece, Portugal).

The concern for markets is that there has been a backlash against austerity measures in Europe which will make the situation worse in the long term. Many commentators are now putting a 50% probability of Greece leaving the Eurozone. The worry is that this will lead to a domino effect with the weaker countries dropping out and disrupting markets.

In the USA the recent economic data has been below expectations, particularly the jobs data. The jury is still out on China having a soft landing. All the recent data points to an economy that is still slowing substantially and we are not sure when it will hit bottom. In Australia the budget surplus amounts to a tightening and has given the RBA room to cut interest rates.

We said in our last note that the European debt situation will not be solved this year and this problem will be with us for years to come. We also said that equity markets remain vulnerable to shocks from Europe and given the recent run up they could easily have a pull back from here. Both these scenarios have eventuated.

Outlook and Markets

Right now we would be very underweight in bonds as the yields have fallen to historically low levels. The following quote from Schroders encapsulates our view.

“Bond yields however, have fallen to unprecedented levels in Australia - supported directionally by a weakening in consensus expectations regarding Australia’s growth outlook, but also due to the purchasing of Australian government bonds by buyers seemingly insensitive to price. We continue to view yields as too low and fundamentally unsustainable over the medium term. One rough “rule-of-thumb” is to compare the yield on the long term bond rate to that of nominal growth in the economy. We estimate nominal trend growth in the economy at 5.5-6%, well above current nominal yields.”

Our understanding is that 75% of Australian bonds are held overseas (UBS) and these investors are driving yields lower. We also believe that global bonds are just as unattractive.

For low growth investors especially, we would suggest replacing a proportion of your fixed interest or bond portfolio with cash and term deposits. This will result in a lower running yield and you will forgo any capital gains should bond yields continue to fall. However we cannot justify current yields short of a doomsday scenario in the global economy. If you need to hold fixed interest funds we would recommend diversified fixed interest funds where the manager is free to switch between the sectors.

We continue to prefer equities to fixed interest on valuation grounds but investors must be comfortable with the increased volatility. The estimated dividend yield of the Australian equity market at about 5% remains higher than both the cash rate (3.75%) and the 10 year bond rate (3.3%). We have had a tilt to global equities over Australian equities given the high Aussie dollar and continue to do so even after the fall to parity. We continue to believe that dollar cost averaging on pullbacks is the best strategy for investors.

Asset Class	1 month	3 month	1 year	3 years	5 years
Australian Shares	1.43	4.63	-4.44	9.78	-2.32
Global Shares	-1.62	7.21	0.25	2.93	-6.07
Listed Property	5.49	7.09	6.93	14.22	-12.97
Fixed Interest	1.59	2.25	11.22	7.05	7.46

Chart 2. Investment Returns to April 30, 2012 (% p.a.) *Source: Mercer*

Budget 2012 Highlights

Federal Treasurer Wayne Swan has handed down his fifth budget in an attempt to deliver a surplus of $1.5 billion by the end of the 2012 / 13 fiscal year. The following summarises how some of the Gillard Government's quest for a budgetary surplus may affect you.

Superanuation

Concessional Contribution Cap (CC) for tax payer aged 50 and over

From 1 July 2012 the CC cap for workers 50 and over will reduce to the standard level of $25,000 until 30 June 2014. From 1 July 2014 the Government plans to cap the CC for workers aged 50 plus to $55,000 for super members with a balance below $500,000.

Tax effect of reducing to $25,000 the concessional contribution cap

Chart 3 below illustrates the effect of the reduced CC cap on net income tax (taking into account the super contribution tax of 15%)

People aged 50 and over that are currently making contributions over the standard cap of $25,000 will have to revise their strategy in order not to breach the cap come 1 July 2012.

From 1 July 2014 concessional contribution cap is to increase to $30,000 for people under 50 and for those over 50 who have a balance of more than $500,000. Those aged 50 and over will be able to contribute an extra $25,000 if they have a balance of less than $500,000.

Contribution tax increase for high income earner

From 1 July 2012 the contribution tax for that group will be raised to 30% from the current 15%. This form of surcharge will apply to people who have a taxable annual income over $300,000.

The definition of income is very broad and the calculation of the surcharge is not straightforward you may need the help of your financial planner to get the right results.

Marginal Tax Rate from 2012*	34.00%	38.50%	46.50%
Additional Annual Tax payable	$4,750	$ 5,878	$ 7,878
Additional Tax payable over the 2 year period	$ 9,500	$11,750	$15,750

**Chart 3. includes the 1.5% Medicare levy.*

Low income superannuation contribution (LISC)*

This measure and the Super Co-Contribution has already been legislated and was announced on the 29 November 2011 in the Government mini-budget. Low income earners will have their superannuation contribution tax refunded (to their super fund). The refund will be calculated as 15% of the total concessional contribution up to a maximum refund of $500 or to up to $3,000 worth of concessional contributions during the relevant financial year. There will be no LISC (refund) made on behalf of the member if the calculated amount is less than $20.

Superannuation Co-contribution

Effective from 1 July 2012 will reduce the maximum payment to $500 from $1,000 to coincide with the LISC as detailed above. The matching rate will remain at a $1 for $1 however the eligibility threshold will cut out at $46,920, currently $61,920.

*Chart 4 on the left shows the difference in net super contributions between the current rules versus the proposed rules to apply from 1 July 2012.

Adjusted Taxable Income	$25,000	$37,000	$40,000	$50,000
Currennt Rules	$	$	$	$
Required Contribution	1,000	831	731	39
Maximum Co-contribution	1,000	831	731	397
Net Super Contribution	**2,000**	**1,662**	**1,462**	**794**
Proposed Rules	$	$	$	$
Required Contribution	500	331	231	0
Maximum Co-contribution	500	331	231	0
LISC*	338	500	0	0
Net Super Contribution	**1,338**	**1,662**	**462**	**0**
Net Gain (Loss)	**-662**	**0**	**-1,000**	**-794**

**Chart 4. Based on employers super contribution obligation (9%)*

Retirement Income

Transition to Retirement Pension (TTRP)

People 55 and over with a TTR strategy in place should have this reviewed as the proposed reduction in the concessional contribution cap to $25,000 for people aged 50 and over could significantly reduce its effectiveness.

People will need to ensure that they not receive surplus pension payment, which is taxable when aged under 60 and cannot be salary sacrificed back in their super.

People with annual income of $300,000 and over will have to assess the impact of paying the higher tax rate of 30% on their concessional contributions.

Minimum pension payments

The pension drawdown of 25% relief has been extended for another year from 1 July 2012 with standard percentages to resume in the 2013 14 financial year.

Age	2011/12	2012/13	2013/14
Under 65	3.00%	3.00%	4.00%
65-74	3.75%	3.75%	5.00%
75-79	4.50%	4.50%	6.00%
80-84	5.25%	5.25%	7.00%
85-89	6.75%	6.75%	9.00%
90-94	8.25%	8.25%	11.00%
95 +	10.50%	10.50%	14.00%

Taxation

Tax Rate & Low Income Tax Offset

Personal marginal tax rate, thresholds for low income level and the Low Income Tax Offset (LITO) have been legislated as part of the Clean Act Energy Package (carbon tax) and will take effect on 01 July 2012. Details can be found on page 3 of the summer 2011 edition of the Personal Wealth newsletter.

Medicare levy

For the 2011 12 financial year the Medicare levy low income threshold will increase to $19,404 (up from $18,839) for singles and $32,743 (up from $31,789) for families with an additional amount of $3,007 (up from $2,919) for each dependent child or student.

Single pensioner below Age Pension age will see their thresholds increase to $30,451 for the same period.

Flood levy

This levy will be abolished come 1 July 2012 thus increasing cash flows for people with a taxable income over $50,000.

Tax Offsets

- **The Pensioner Tax Offset** - will be abolished from 1 July 2012 and eligible individuals will qualify for the Senior Australian tax Offset (SATO) instead. SATO will also be renamed the seniors and pensioners tax offset (SAPTO)

- **Net Medical Expenses Tax Offset** - a means test will be introduced from 1 July 2012. This means that people with adjusted taxable income above the Medicare levy surcharge thresholds will see the amount which they can claim increase to $5,000(currently $2,000) and the rate refund reduce to 10% (currently 20%). People with income below the surcharge thresholds will not be affected.

- **Mature Age Worker Tax Offset (MAWTO)** - will be phased out from 1 July 2112 for workers born on or after 1 July 1957. But will be maintained for tax payers who are aged 55 or older by 30 June 2012.

- **Dependency Tax Offsets** – from 1 July 2012 (for the 2011 / 12 financial year) the Government will consolidate eight dependency tax offsets* into a single, streamlined and non-refundable offset that is only available to tax payers who maintain a dependant. The new consolidated offset will be based on the highest rate of the existing offsets it replaces, resulting in an increased entitlement for many of those eligible for this measure. Taxpayers who are currently eligible to claim more than one offset amount in respect of multiple dependants will still be able to do so.

**Invalid spouse, carer spouse, housekeeper, housekeeper (with child), child-housekeeper, child-housekeeper (with child), invalid relative and parent/ parent-in-law tax offsets.*

- **Education Tax Refund (ETR)** - from 1 January 2013 the ETR will be replaced with the new Schoolkids Bonus. The Schoolkids Bonus will be paid to eligible recipients in two equal instalments in January and July each year without any proof of purchase.

Every family with a child at school will receive an annual amount of $410 for each primary school student and $820 for each secondary school student.

As a transitional arrangement the ETR in 2011/12 financial year will be replaced by a one-off lump sum payment automatically to eligible families in June 2012.

Not Proceeding

The promised 50% tax discount on the first $1,000 interest and the company tax reduction will not proceed.

Business

Small businesses (run through a company) will be able to claim back tax paid in prior years where a loss is made in a year. There are some conditions attached to this and you will need to discuss these matters with your accountant.

Social Security

Family Tax Benefit Part A (FTB A)

Effective 1 January 2013 eligibility will be limited to young people under age 18 or if they remain in high school, the end of the year in which they turn19, as opposed to the current age of 22. The rate will increase by an annual amount of $300 for a family with one child and $600 for a family with two or more children. The base rate will increase by $100 for single child families and $200 pa for families with 2 children or more.

Age Pension

From 1 July 2014 age pension recipient who are overseas for more than 26 weeks will be paid the maximum entitlement only if they have been working 35 years in Australia currently 25 years. Proportional payment will be made to those who have worked less than 35 years in Australia.

Parenting Payment

All single unemployed parents will be able to receive the Parenting Payment until their youngest child turns eight. After that they will need to move to another payment such as Newstart Allowance where they will have to look for work. For partnered parents the payment will stop when their youngest child reaches age six.

Carbon Tax Compensation Measures

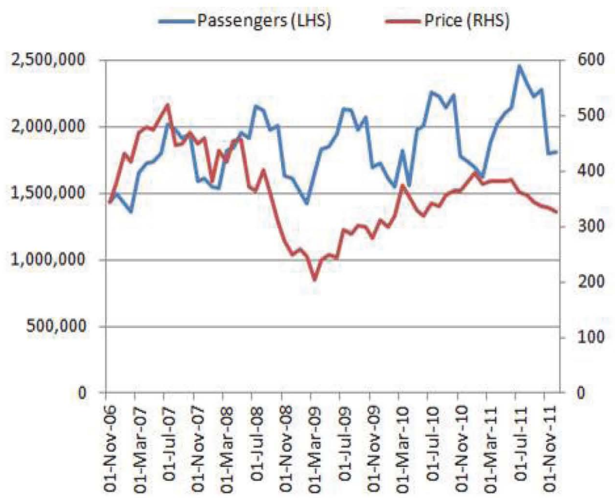
Under the previously announced Carbon Tax Compensation Measures Centrelink recipients will receive the Clean Energy Advance payment between May and June 2012.

CREATIVE DESTRUCTION

One of the greatest challenges of investing is the proper assessment of risk. According to Hunter Hall's Dr Roland Winn understanding the nature of true risk and the opportunities afforded by "Creative Destruction" are essential for making the most of opportunity.

"Creative Destruction is the opportunity that gets thrown up by a crisis when an major adverse event occurs. Often in the midst of that disruption windows of opportunity are created. Capitalising on these opportunities amidst all the noise is one of the qualities that makes for a successful investor" says Dr Winn.

Speaking at Hunter Hall's recent Roadshow at Sydney's Ivy, Dr Winn discussed a case study that demonstrated his point. "Zurich Airport is a great example of how we were able to enter a very appealing stock at an attractive price seemingly in the midst of destruction. I feel this stock has been surprisingly underestimated by the market and its resilience and potential for growth are yet to be appreciated. This stock has been disproportionately punished by investors for fleeting events that have done very little to change the underlying intrinsic value of company."

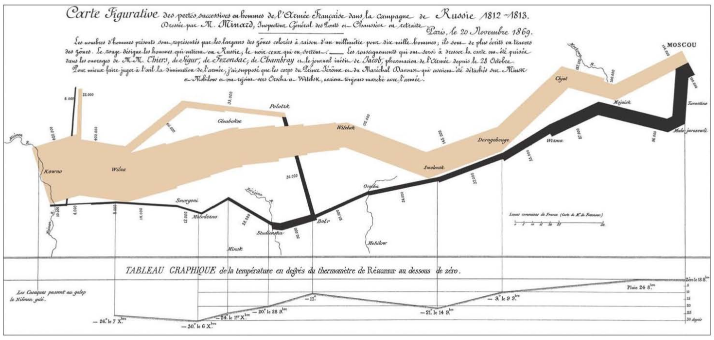


Zurich Airport a resilient stock according to Dr Winn

"You can see that the key value driver, passenger traffic, has performed very well on a long-term basis, despite significant events like the GFC, oil shocks, several mid-East wars, the bursting of the dot-com bubble and other watershed moments in recent economic history. Unlike your average investment, it has a relatively captive and stable customer base, higher operating margins, and strategic options for untapped value such as surplus land for development".

Dr Winn invested in Zurich Airport during the GFC and increased Hunter Hall's position during the eruption of the Eyjafjallajökull Icelandic volcano in 2010. During this 'destructive' event an investment opportunity was created by the impression of damage to the company's value. The market was very short-sighted and got this wrong according to Dr Winn, as business was back to normal very quickly.

"The discipline for investing in the midst of destructive events is the proper assessment of risk" according to Dr Winn, he uses a famous historical chart by Charles Joseph Minard to illustrate.



Creative Destruction -
Charles Joseph Minard's chart of Napoleons Quest for Russia

"This is a chart that describes Napoleons quest for Russia and it describes how his army of over 440,000 was reduced to some 20,000 soldiers. When Napoleon began this enterprise he believed the biggest risk to his force was the Russians. However, only a quarter of the original forces made it to Moscow and more soldiers were lost to typhus, desertion, disease, and the elements than combat. Ultimately, the perceived – subjective - risks were outdone by the objective, physical morale-sapping risk of the Russian winter".

Dr Winn notes "In the midst of significant market events it is extremely important to distinguish between subjective and objective risks. By definition subjective risks are based on perceptions vs objective risks which should be measurable. In our assessment of Zurich Airport we have identified significant objective risks like the events just described. Around these moments of Creative Destruction, the market is often driven by overestimation and fear of subjective risks which create opportunities for objective long term investors."

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