

Nine steps to building your first bond portfolio

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SMART INCOME



In the wake of the global financial crisis, retail investors have looked afresh at the “balance” needed in a robust and diversified portfolio. There is a renewed awareness of the volatility of markets and the need to diversify investments to hedge against it.

As many investors found out the hard way in the dismal stockmarket years of 2008-09, private portfolios should not be 100 per cent invested in a single asset class let alone a single venture. The only exception would be a 100 per cent cash allocation to government-guaranteed term deposits.

But a “no risk” strategy has its own problems and in this environment where RBA governor Glenn Stevens describes rate levels as the “the lowest in history” it means cash offers very low returns and the strategy, while safe, may not deliver enough income to live. Once again, finding a balance is important.

Bonds are a great diversifier and can help protect your wealth and income throughout various economic cycles while providing better returns than term deposits. There are times when bonds are better than others, but a smartly constructed bond portfolio will offer solid ballast to any portfolio at virtually any stage in the market cycle.

If you are new to bond investment, here are some questions that may help you determine how much of your portfolio you should allocate to defensive assets.

1. How much income do you need to maintain your lifestyle? Investing in securities that have a known income will help achieve these goals.

2. How much capital do you need to maintain your lifestyle? Many investors have aspirations to leave a specific amount to children and grandchildren; how do you make sure those funds are preserved?

3. How old are you? The older you are the less time you have to recover lost capital. Also as you age, your earning potential may decline, and you may not be able to work to recover any losses. Investors should consider that they generally need to be more protective of capital as they age and if you don't have enough

capital to support your lifestyle when you retire, then it's not a good time to invest a high proportion in high-risk assets.

4. Do you have any known future expenses? If you know you need funds for an event like a wedding or holiday, these funds should be set aside. Bonds can be acquired with cashflows and maturity dates to suit known future expenses.

5. What is your risk appetite? More appropriately, how much are you willing to lose?

6. Do you have the capacity to earn income to supplement losses? If you still work, even part-time, that income will help protect your lifestyle and allow you to take additional risks.

7. Is your portfolio diversified so that the investments you hold are across different industrial sectors, have varying maturities and risk profiles? Diversification is key to running a successful SMSF. To achieve a diversified fixed income portfolio you

Diversification is key to running a successful SMSF

should hold different types of bonds, such as fixed and floating rate notes, inflation linked and government bonds. A portfolio with a 100 per cent allocation to shares is not diversified; in the GFC, the value of practically all shares declined.

8. How liquid is your portfolio? If you need to access a large sum quickly, can you do so without losing value on the investment?

9. What return do you aim to achieve? This is often the first consideration of investors and while important should be considered in light of the above. Remember higher returns often mean higher risk.

By considering these factors and discussing them with others in your SMSF or your financial adviser, you'll have taken the first strategic steps towards building a bond portfolio. The next step is to begin the construction of a portfolio that suits you and becoming familiar with the wider market so you can make tactical moves which will help optimise your investment.

Moreover, a wider understanding of the bond market will mean you are better prepared when making decisions about which investments to include in your portfolio.

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Super changes are constant

But politicians will ensure they have bipartisan support

ANDREW MAIN



For all the talk that Australia's superannuation system is an unfair shambles, it's not.

Maybe it's the way the proposed tweaks get reported, with righteous indignation sometimes getting more airtime than analysis of the changes by government or opposition, but the simple reality is that no politician is going to monkey around with super unless they get bipartisan support to do so.

Let's start with the recent budget, and things we do know.

The big positive for the 80 per cent of retirees on a partial or full pension is that the government has withdrawn the threat to index pensions to the Consumer Price Index rather than the faster-growing average male weekly earnings.

That's a big positive for pensioners, but nowadays budget measures are a zero sum game. It must be paid for by a change to the assets test for access to a pension.

Starting in January 2017, the government has axed the non-sense of offering a partial pension to couples who have up to \$1.15 million socked away in assets, as well as their house. That is also a positive.

And it's good for everyone with assets below \$300,000 plus their house, but the doubling of the “taper rate” by which the pension disappears as asset totals rise means that couples with \$700,000 in assets, plus their house, will be worse off than people with half the portable assets who are on a full pension.

Social Security Minister Scott Morrison has said critics of that anomaly “fail to understand” the fact that to maintain their income self-funded retirees would merely have to lift by 1.8 per cent the rate at which they draw their assets down, but that statement hasn't set church bells ringing.

Morrison stressed that they were expected to drop off the perch having spent most of their savings, but that flies in the face of decades of Coalition core statements about hard work and self-reliance.

You can assume the government won't change that taper rate and Labor, most of whose voters



KYM SMITH

Bill Shorten has proposed imposing a tax of 15 per cent on retirement income in excess of \$75,000 per person per year

end up on a full pension eventually, is not going to change a ruling that helps most of its supporters.

But changes to super change the way people behave and many savers negatively affected by the change will work the rules, for instance fixing up their house to improve their access to a part pension. That will have the exact opposite effect to what the government is trying to do, reduce retirees' still overwhelming dependence on the pension.

To corrupt a phrase, the road to legislative change is paved with unintended consequences.

Joe Hockey has retreated from his line that the Coalition would not tax retirement incomes before or even after the coming election, last week telling the ABC's Q&A program that “at some point, and now is not the time, and it won't be for a while, but at some point we have to look at the future of the entire retirement income system”.

We got Treasury numbers say-

ing the tax concession for superannuation contributions is set to climb to \$20.15 billion by 2018-19.

If you add that to the cost of *not* taxing retirement pension earnings, which will be \$30.4bn at the same time, the combined sup-

The road to legislative change is paved with unintended consequences

posed cost of the two concessions will come to almost the same as the \$50.4bn that will be spent on the pension.

The one to be careful of there is the first number, \$20.5bn, since it's well known that if smart savers don't get one tax concession, they'll find a way to get another.

So, over the long run, even as our superannuation system matures, something will have to give to avoid a permanent budgetary black hole thanks to our ageing

population. So what will our political leaders do in the short to medium term?

Let's eliminate a few things they can't or won't do:

- They won't knock out dividend imputation because if they do, they're effectively taxing company dividends twice.

- Negative gearing? Abolishing it would be even more political dynamite than dividend imputation, as there is a big number of people lower down the financial food chain whose only significant asset outside their primary residence is an investment property

So ... to the big one, taxing income streams in retirement. Opposition Leader Bill Shorten has proposed imposing a tax of 15 per cent on retirement income in excess of \$75,000 per person per year.

The reality of the proposal is that it would only affect individual retirees who have personal super of close to \$2m socked away, or \$4m for couples. It would impose the same tax as is already

imposed in contributions and accumulation, 15 per cent. So in reality, if a retiree were collecting \$100,000 a year from their super, they would be up for an extra \$3750 a year ... or just over \$72 a week.

In summary, taxing super is all a balancing act and all governments must be aware that any reduction of the incentive to save for retirement risks blowing out the age pension bill even further. Grumbling about tax breaks for the rich must be balanced against the need to keep as many people as possible off the pension.

And whatever they do, the Coalition or Labor, any measure must be given as long a lead-in time as possible to allow savers (and spenders) to adjust to the new regime.

It's unrealistic to assume government will never touch superannuation, since nothing ever stands still, but as long as changes are intelligent and well considered, we won't all be quite so “rooned” after all.

FLOAT WATCH

Insurer plans for costs of friends

Greenstone

ASX CODE: GRS
SHARES ON OFFER: 398.6m
LISTING PRICE: \$2-\$2.50
MARKET CAPITALISATION: \$1396 million-\$1713m
LISTING DATE: June 15

TIM MORRIS

Pet ownership rates in Australia are among the world's highest. According to the Animal Health Alliance, more than 60 per cent of households own a pet, with dogs in 40 per cent of households and cats in 30 per cent. By comparison, the European Pet Food Federation reports dog and cat ownership in Britain to be 24 per cent and 19 per cent respectively.

To date, the nation's affinity for furry friendship may have coincided with little planning for the associated costs. It is estimated that only 4 per cent of cats and dogs are subject to pet insurance in Australia, compared with 25 per cent in Britain.

The world's most prepared pet owners appear to be the Swedish, where 40 per cent of cats and dogs are subject to insurance despite having one of the EU's lowest rates of pet ownership.

The coming listing of Greenstone aims to ensure that Australians are more financially prepared for unforeseen events involving their pets and personal health.

Founded in 2007 by private South African insurance group Holland, Greenstone is focused on the development, marketing and administration of retail insurance products in Australia. The company has a direct-to-consumer distribution strategy. Its principal assets include distribution and administration agreements with Hannover Re, Woolworths, Medibank and the RSPCA.

Greenstone also controls intellectual property surrounding proprietary brands including Real Insurance, Prime Pet Insurance, Guardian Insurance, Australian Seniors Insurance Agency and Choosi.

With impetus for Greenstone's listing driven by a vendor sale, incentive for new investors is provided by the company's established profitability and growth record. Greenstone is on course to generate its third consecutive year of increasing profits during the 2016 financial year and is scheduled to pay dividends.

While vendors will retain a significant stake in the business, there are risks surrounding the company's earnings quality. Greenstone's financial performance is heavily reliant on new sales rather than recurring income. The company has successfully diversified with a portfolio of life and other health-related insurance products. However, its mixed history of cashflow conversion elevates the balance of risks.

Tim Morris is an analyst with wise-owl.com.

Two types of house and land packages for DIY funds — know the difference

MONICA RULE



Residential property investment is becoming increasingly popular with self-managed superannuation fund investors, and I'm often asked whether SMSFs can purchase house and land packages.

It's a good question because not only would the SMSF hope-fully achieve some long-term capital gain, it would also be entitled to claim some depreciation on the new asset as it ages.

In answering this question, I always clarify first whether my clients want to purchase a house and land package or purchase a vacant block of land and then

build a house on it. What is the difference? It can make a huge difference in the SMSF world, especially when there are borrowings involved.

You see, an SMSF can borrow money to purchase a house and land package as long as it is purchased together in the one transaction as a single acquirable asset where the asset is identified upfront as vacant land with a completed house on it.

Whereas, if an SMSF purchased a block of land with borrowings and then later built a house on the land, this would not

be allowed under the limited recourse borrowing arrangement.

The superannuation law does not allow the single acquirable asset, in this case the block of land, to be improved (by building a house on it) while the loan remains outstanding. There is a very good reason for this.

The borrowing rule is referred to as a limited recourse borrowing arrangement. It means the lender's rights, on any default on the borrowing by the SMSF, are limited to the single asset acquired under the arrangement. This means the lender does not have

any claim on any of the SMSF's other assets. The borrowing is quarantined to the single acquirable asset. The law is designed to protect the remaining assets within the SMSF in the event of a default by the SMSF.

So, if an SMSF borrows to purchase a block of land and later builds a house on the land, and then due to some unfortunate financial circumstances cannot repay the loan, the lender will take possession of the asset from the SMSF — which is now a property consisting of a house and land.

The money that the SMSF

spent on building the house on the vacant land is lost as it cannot be recovered from the lender.

To make matters worse, the SMSF has also contravened the limited recourse borrowing arrangement and would be in trouble with the tax office.

The important things to remember for SMSFs in acquiring a house and land package using borrowings are to ensure that you identify upfront that the single acquirable asset is the land with a completed house on it; the lender's security on the borrowing is at all times over the land and the com-

pleted house; and, the limited recourse borrowing arrangement with the lender allows for multiple drawdowns for the deposit, progress payments and the final payment at settlement.

House and land packages can offer great investment opportunities for SMSFs. But if you don't comply with the law, your investment could be a costly mistake.

Monica Rule is an SMSF specialist adviser and the author of SMSFs and Properties.

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