INVESTMENT SOLUTIONS

AUTUMN 2015

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HuntWealth

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Welcome

Investment Solutions

Autumn 2015

With investment properties in Australia being hit by falling rental earnings we examine if buying into Australian property is still a good investment.

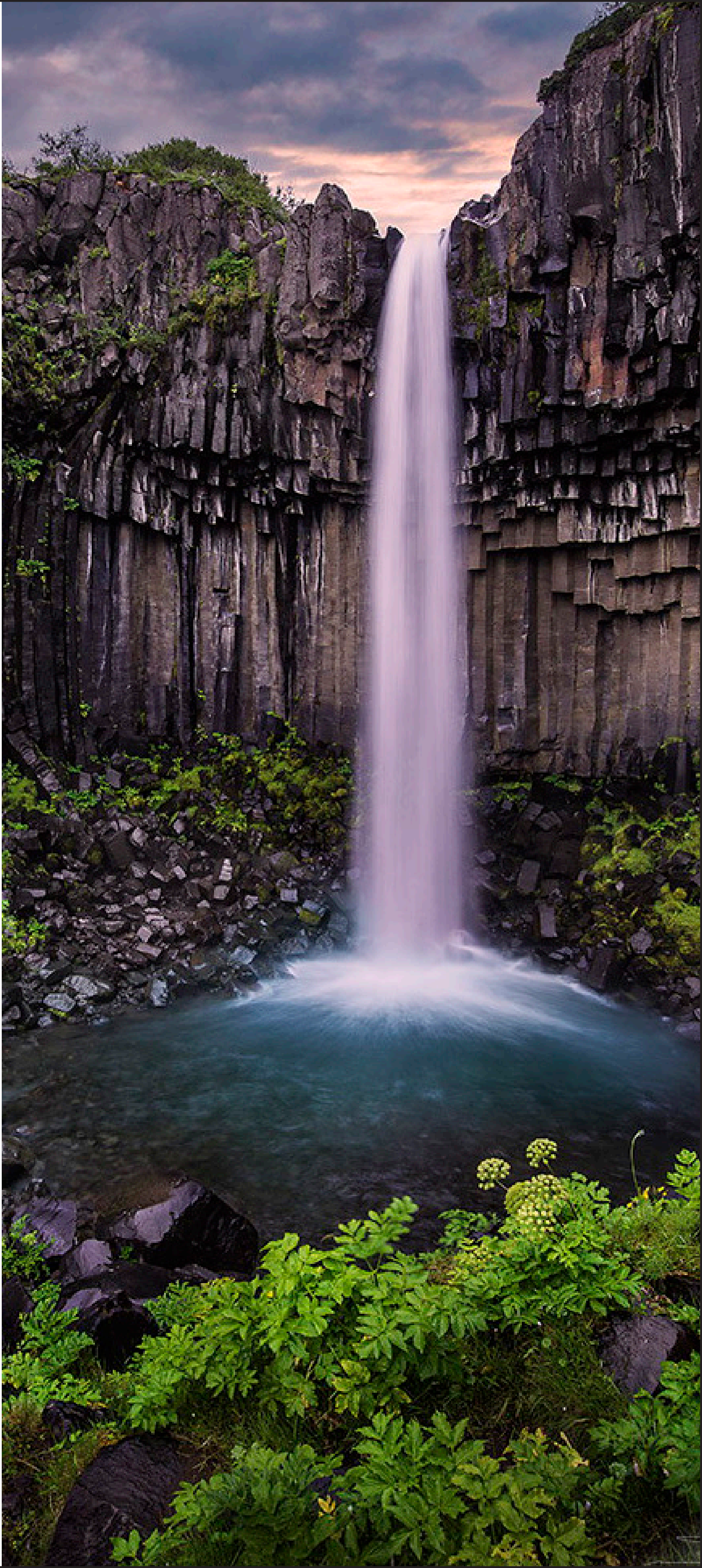
We also discuss how the recent Australian Tax Office (ATO) changes to assessable income rules around SMSF borrowings may impact the tax you pay.

Our regular Market Update from Piers Bolger, Head of Research & Strategy at BT Financial Group, looks at the performance of overseas and local markets.

Finally, we remind everyone of the importance of having insurance and ask if you and your family can afford not to be protected.

Until next time – happy reading.

Hunt Wealth
Shaun Hunt B App Fin | Adv Dip FS (FP)
08 8364 6555
shaun@huntwealth.com.au
www.huntwealh.com.au



Market update

Investors have endured volatile market conditions so far in 2015. While economic growth is improving in the US and UK, in other regions it has been more subdued.

Global overview

On the whole, growth in Europe has been restrained, after achieving some momentum in early 2014. This led to the European Central Bank starting a quantitative easing (QE) program. After missing its growth forecast, China's central bank also cut lending rates and its Reserve Requirement Ratio (RRR). In addition, central banks around the world, including Australia, have maintained an aggressive approach to monetary policy, reducing official cash rates in early 2015. It's worth noting the Danish central bank cut rates on three separate occasions in January after the Swiss National Bank's decision to break the Swiss franc/euro currency peg.

There has also been a sharp decline in commodity prices, reflecting a weaker global economic environment. Oil, iron ore, copper, gold and natural gas are some of the commodities whose values have fallen over the last 12 months. At the same time there has been an increase in supply from producers in an attempt to reduce the number of higher marginal cost competitors in the market. The challenge with this strategy is the extent to which producers can tolerate lower absolute prices in an environment where inventory levels are rising. While lower commodity prices have a positive effect on the broader global economy through cheaper input costs for businesses and cheaper goods for consumers, to date the impact has been minimal as consumers and business remain cautious.

There is also a mixed outlook for growth on a regional basis. The US and UK economies continue to maintain steady momentum. But the short-term growth outlook remains opaque for Europe, Asia – including China and Japan – and some emerging market economies such as Brazil. As a result the World Bank has reduced its growth forecast for 2015 to three per cent, the lower end of its range.

Overall, however, emerging market economies are set to drive growth this year. This should be positive for higher risk assets such as emerging market equities. But returns are likely to be volatile and investors should be prepared to hold positions for an extended period to achieve high values for assets in this category.

At home

Financial markets have experienced gains stemming from higher liquidity as a result of central banks' monetary easing policies. Bonds and equities did well throughout 2014. From a global perspective the fall in the Australian dollar has delivered additional returns for investors. We expect the Australian dollar will continue to trade lower through 2015. The 'steady as she goes policy' adopted by the Reserve Bank of Australia (RBA) since September 2013 has now changed, with the bank reducing the official cash rate by 0.25 per cent to 2.25 per cent in February, an all-time low. In its statement the RBA noted while the cash rate had remained steady for an extended period, based on updated forecasts of both domestic and global factors it felt a further reduction was appropriate.

Now having played its hand, the challenge for the RBA is that it will be difficult to stop at just one cut. In our view, the decision had much to do with other global central bank decisions in January and market perception as opposed to a real need. What is clear, however, is that the economy is moderating and the growth outlook remains muted. This has seen inflationary expectations drop below the RBA's two per cent target level.

While low inflation numbers can be linked to a decline in commodity prices, lack of good governance and policy remains the sticking point. More needs to be done to encourage an environment in which businesses are prepared to invest and seek out growth opportunities. The unemployment rate has also steadily risen, putting further pressure on both policy makers and the RBA.

Looking forward

Overall, we believe the domestic economy will continue to slowdown. The level of political uncertainty across a range of areas is reducing the ability of the economy to transition from the mining boom. Lower cash rates can only be of limited use if they are not supported by proactive and constructive policy.

From a broader market perspective the near term fortunes of the economy will be linked to the global macro outlook, especially Chinese growth, as much as to domestic issues. Consequently the medium term outlook remains challenging.

Is property still a good investment?

Investment properties in Australia are being hit by falling rental earnings. So is it possible to still make money from investment properties? We consider the challenges and opportunities of the current Australian property market and how to navigate both.

Jumping on the investment property bandwagon

Australian investors are continuing to enter the market in large numbers, especially in Sydney and Melbourne; driven in part, by low borrowing costs and rising prices, which are both very attractive. Home loans to landlords now account for more than half of all mortgages, the highest share on record.

Increasing property prices

House prices in major Australian cities rose 8.2% in the year through December 2014, according to CoreLogic Inc – the largest property data provider in the world. They have climbed 12.4% in Sydney (the most of all Australian cities) and 7.6% in Melbourne. So in terms of capital gains – in the major cities at least – property is still performing well as an investment.

Falling returns

The downside is that these higher prices coincide with an increase in the supply of homes for lease, which is causing rental earnings to fall.

A quick snapshot across eight states and territory capitals in October 2014 shows rental earnings dropped to 3.7% for houses and 4.5% for apartments. That's a drop from 4% and 4.7% a year earlier, CoreLogic figures showed. The result is that investment properties are getting more expensive to buy and returning less cash flow through rent.

Warnings

There's been a lot of debate about the Australian 'housing bubble'; the argument being that the current property market is overinflated and prices are due for a fall. Late last year, The Reserve Bank of Australia warned that the increase in investor lending might be, "a sign of speculative excess". The implication is that investors may be paying too much and are at risk of a period of negative equity. This timed with falling rental earnings, makes investing in property look increasingly high risk in the short term.

"...higher prices coincide with an increase in the supply of homes for lease, which is causing rental earnings to fall"

Six tips to consider

If you are an investor or looking to invest in property, here are six things you can do to mitigate some of this risk.

1. **Get some up-to-date advice.** Revisit or even rethink your investment strategy by speaking to your financial adviser. Your financial goals will determine whether property is good for you in the short and long term.
2. **Take a long-term view.** All types of investments go through cycles of growth and retraction – property is no different.
3. **Do your research – look for hot spots.** Having the right location is key when looking to invest in property. You should be on the look out for areas that have future growth potential. These areas might not be fashionable but they make good investment sense. On top of this, you may be able to purchase an affordable property that can potentially grow in value in a short period. Also consider regional and commercial property, which at times can perform better as an investment.
4. **Don't get in over your head by borrowing too much or overcapitalising.** Do the math between what you need to spend on a property, the rental returns and the projected capital gains. Make sure you have a plan about how to cover the shortfall if interest rates go up.
5. **Make sure you're getting all the value you can through gearing and other tax strategies.** Again speak to your financial adviser about how to maximise these.
6. **Diversify your investments.** A balanced investment portfolio should include a range of asset classes, not just property. In fact property, depending on your stage of life and financial goals, may not be the best choice for you. Again, get good advice.

How to avoid an SMSF tax penalty?

The Australian Tax Office (ATO) has recently changed the way it assesses income earned by assets paid for by a Self Managed Super Fund (SMSF) borrowings. In some cases, income earned by assets in this category will be treated as non-arm's length and won't qualify for the tax concessions available within super. Instead, these assets may pay tax at a rate equal to the top marginal tax rate, currently 47%.

Let's say an SMSF borrows funds to buy an investment property and the borrowing arrangement is deemed to be one where the non-arm's length income rules apply. The rental income from the property would be taxed at 47%, rather than the 15% tax rate that applies to SMSF income for accumulation accounts, or the 0% tax rate that applies when rental income supports a pension paid by the fund.

It's important to note that the ATO will only apply these rules in a very limited number of cases where it has concerns about related party borrowings. It has said there's nothing wrong with a related party providing the funding for a SMSF's borrowing. The loan could be provided by a member of the fund, a relation of a member or any company or trust controlled by the family.

However, the ATO has said it has concerns about three facets of some related party loans where the SMSF and the lender don't deal with each other as if unrelated:

1. The first issue occurs when related party lenders charge the SMSF artificially low or no interest to increase the benefits retained in the SMSF and maximise the income earned by the asset. For example, if a member loans funds to their SMSF, which uses them to acquire a property, the SMSF pays the member interest from the rental income. The member is obliged to declare the income in their tax return and pay tax on it at their marginal tax rate. But if they don't charge interest the member won't have income from the loan to declare for tax purposes. The ATO says this is a "scheme" and lenders should always charge a commercial rate of interest.
2. The second issue relates to lenders who provide nearly all the funds to buy the asset. SMSF loans are limited recourse in nature, so in the event of a default the lender can only take possession of the asset acquired with the borrowed funds. The ATO says when the lender provides most of the funds to buy the asset it should seek mechanisms to recover its funds such as guarantees from members using non-superannuation assets.
3. The final issue is the regularity of payments. Some loans have been set up with a single repayment of the loan at maturity, up to 20 years in the future. The ATO says this situation would be unlikely if the lender and borrower weren't related and prefers to see regular repayments.

Borrowing within SMSFs can be an effective, although complex strategy. There can be serious consequences such as higher tax payments if mistakes are made and it's essential to seek professional advice from your financial adviser before borrowing to buy an asset within a super fund.

Can you afford not to be protected?

If you travel, especially overseas, you know the importance of travel insurance – lost luggage anyone? And if you have a car or motorbike then you know it's a no brainer to insure your wheels.

But there are other kinds of insurance even if you're young, single and healthy today that are important to help you protect your lifestyle and independence.

Protect your income

Income Protection can help you pay your rent or mortgage, cover medical expenses and bills and continue to fund your lifestyle if you can't work because you become sick or injured. If you're not sure you need Income Protection insurance, ask yourself how long you could continue to meet your day-to-day living expenses if you suddenly were unable to work for a lengthy period of time?

Trauma insurance

Another insurance worth noting is Trauma insurance which provides a lump sum payment when you suffer a major medical illness. Trauma insurance can help ease the financial stress of major expenses to give you financial peace of mind so you can focus on what's truly important – your recovery.

Save money

There are many good reasons why it is essential to take private health insurance especially while you're young and healthy. The first is that it can save you money. Private health insurers offer Lifetime Health Cover which is designed to encourage people to take out hospital cover early in their life and keep it.

Because of this, health insurers must charge extra to people who join a hospital policy after the age of 31.

The extra charge is 2% on top of the normal premium for each year you are over 30 years of age. For example:

- If you don't take out hospital insurance until you are 40 you'll pay an extra 20%.
- If you wait until you are 50 it's an extra 40%.

Avoid the surcharge

The Medicare Levy Surcharge (MLS) occurs if you don't have private hospital cover. This means for most people who are single with a taxable income over \$90,000 (\$180,000 for couples, families and single parents) the government will charge an extra 1% in tax.

The MLS will increase to 1.25% if you earn over \$105,000 (\$210,000 for couples, families and single parents) and 1.5% if you earn over \$140,000 (\$280,000 for couples, families and single parents).

According to iSelect – the private health comparison website, depending on your circumstances, you may be able to buy basic hospital cover that is cheaper than the surcharge that has to be paid in additional tax.

Apart from saving money, having to self fund medical care, for example knee surgery after that stack skiing last season can cause a serious dent in your savings.

While taking out insurance is a personal choice, you must remember that nothing in life is predictable and you should look at how you can protect yourself and your family in those uncertain times. For the best advice about which insurance is best for your circumstances, please talk to a financial adviser.