

Newsletter

Summer 2011

Welcome

Welcome to our Summer newsletter; we hope you enjoy the diversity of topics, starting with a focus on recent investment returns.

The results are now in for the 2010–11 financial year and hedged international shares topped the poll, while the same asset class, unhedged, brought up the rear. Our article looks at what hedging means, how it works, and the impact it can have on portfolio returns.

In difficult times, we all tend to look for a silver lining. For some of us, this comes as an inheritance or windfall. However, once the initial excitement fades, how do you make sure you take advantage of your good fortune, especially if you are choosing between cutting your mortgage or boosting superannuation?

Finally, we look back at the life of the visionary Steve Jobs, the man behind Apple and the iPad, to see what we might learn from this leader who started with nothing and inspired millions.

Kind Regards,



Scott Farmer

Latest news

Summertime may have arrived in Australia but as the northern hemisphere moves into winter, lingering concerns about debt, banks and economic growth in Europe and the United States are starting to affect economies in other regions, including our own.

The good news is that China seems to be slowing growth, in order to reign in inflation, without bringing the economy to a halt. Of concern however, is that their important export markets include the US and Europe, both of which are struggling.

The danger for the stronger Asian and Australian economies is that as international credit flows tighten, it will affect funding costs for local banks.

Locally, the sharemarket roller coaster continued with October rises followed by falls in November. The Aussie dollar has dropped below parity, reflecting lower commodity prices, but its strength is biting into manufacturing, especially steel. As a result, the local labour market is softer.

Housing prices remain subdued but overall construction figures are strong. October brought a cut in interest rates and another may be in the offing. It remains to be seen how that flows into both housing and retail spending, but it has already lifted consumer confidence levels.

In the months ahead, there could be quite a bit of heat in the economic sun.



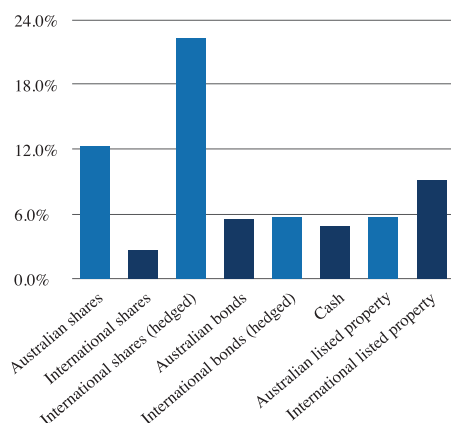
HEDGING

against uncertainty

Australians love a winner and for the past year the Australian dollar has been punching above its weight on global currency markets. The strong local currency is a windfall if you are planning an overseas holiday, but it is bad news for overseas investments that are not hedged against currency movements.

As the chart below shows, in the year to 30 June 2011, hedged international shares were the best performing asset class with a return of 22.3 per cent, streets ahead of local shares, bonds and property. However, unhedged international shares were last year's wooden spooners, with a return of just 2.7 per cent.

2010–2011 financial year total returns (%) by asset class



Source: Vanguard® 2011 Index Chart

The difference in returns came down to the soaring Aussie dollar. In the year to June 30, the Australian dollar appreciated by almost 29 per cent against the US dollar, up from US\$1.07.

When you buy overseas assets you pay for them in Australian dollars, converted into local currency at that day's rate of exchange. When you sell, the proceeds are converted from local currency back into Australian dollars. If the Australian dollar rises during that time it reduces the value of your investments, and vice versa.

What is hedging?

Hedging is a form of risk management used by companies and fund managers to lock in a future exchange rate or asset price. Think of it as an insurance contract against adverse currency fluctuations. There is a cost to these contracts so investors need to take this into account when making the decision to hedge or not to hedge.

Global opportunities

Local investors are generally advised to allocate some of their money to overseas investments to spread their risk and boost returns, and rightly so. The Australian sharemarket is a minnow by world standards, at just 2.5 per cent of the global sharemarket value.

One approach for local investors might be via an international share fund, with the fund manager looking after any hedging strategy.

Alternatively, you can buy shares in Australian companies with overseas operations. Often these companies manage their own currency hedging.

Hedging is important for Australian mining companies which face a double whammy when it comes to exchange rates. Not only do they have to deal with currency fluctuations when they export the metals and minerals they

produce, but commodities are priced in US dollars. Some local gold miners, for example, hedge against unforeseen changes in international gold prices. They might also hedge against exchange rate fluctuations. Other gold miners choose not to hedge at all.

There is no right or wrong answer to the question of whether to hedge or not to hedge. Currency fluctuations tend to even out over time, as do the returns from hedged and unhedged investments.

Swings and roundabouts

So before you rush out and buy a hedged international share fund — or anything else, if you are tempted to base your decision on last year's returns — it is worth noting the long-term performance figures. In 16 of the last 30 years, or roughly half the time, it was unhedged international shares which outperformed their hedged equivalent.

Looking at average returns paints a different picture. The average return for unhedged international shares over the past 30 years was 11.5 per cent a year compared with 13.4 per cent for hedged. A difference of 1.9 per cent is not to be sniffed at, but the scales could tip either way depending on your investment timeframe.

Rather than chopping and changing between hedged and unhedged share funds in a vain attempt to catch next year's winner based on last year's results, a better approach is to choose a good quality fund, either hedged or unhedged, and stick with it.



winning **WINDFALLS**

Imagine winning the lottery or great Aunt Sally leaving you all her worldly goods. What would you do? It might all sound wonderful but, interestingly, windfalls like these can present as many problems as they solve.

Among a suite of possibilities, the classic choice of what you should do with a windfall is to either pay off your mortgage or put the money into super. But given that a lottery win or an inheritance is likely to be a post-tax sum, the mortgage route may often prove more effective, despite the appeal of superannuation's favourable tax treatment. In most cases, however, the decision will depend on your personal circumstances.

Can investments earn enough?

A key factor in favour of paying off the home loan is that it is a non-deductible debt; there are no tax advantages or offsets to help service your borrowings. With mortgage rates around the 7 per cent mark you would need to earn at least that amount after tax from your investments to decide against paying off your mortgage.

Admittedly, earnings on your investments in super only attract a maximum 15 per cent tax in the accumulation phase and are tax-free in the pension phase, but you would still need to earn at least an 8.25 per cent return to make it a better option than paying off your mortgage.

A taxing question

Mind you, if Aunt Sally has left you her holiday home or some other asset with a capital gains tax (CGT) liability, when you sell it, then contributions to super might be a way to offset that liability. For this to be the case, you first must be eligible to claim a deduction. This requires you to have no more than 10 per cent of your income derived from employment in the financial year you wish to claim the tax deduction.

For example, if your capital gain was \$200,000 and your CGT liability was on 50 per cent of that (i.e. \$100,000)¹, you could further reduce this liability by making a \$50,000 contribution to super (if you are aged 50 or more; otherwise \$25,000). This could bring the sum on which CGT is payable down to \$50,000. These are all issues you need to discuss with us (and your tax accountant) to ensure your needs and personal circumstances are fully considered. For example, exceeding contribution limits may incur a large tax penalty.

If you are someone who is used to having a mortgage and building an effective family budget around that, consider taking two steps: pay off the mortgage first, and then redraw funds to purchase an investment. If you use that approach, the interest on your loan becomes tax deductible.

Of course, if you don't have a mortgage, consider putting the money into super as a non-concessional contribution. That way you would benefit from the

15 per cent tax on investment earnings rather than paying your full marginal tax rate which could be as high as 46.5 per cent.

Calculating your options

According to the Government website Moneysmart.gov.au, somebody aged 50, earning \$100,000 a year, would be better off paying down their mortgage if they received a \$300,000 windfall, in comparison to making super contributions. The assumptions behind this are the person has a \$300,000 mortgage with 15 years to run at 7 per cent. It also assumes a 3.5 per cent inflation rate and a 7 per cent return on super investments. According to the website, the difference once the person turns age 65 would be \$449,778. And if you had been 40 at the time of the windfall, you would have been \$629,392 better off. It is important to remember however, if superannuation returns were more than 7 per cent, this would reduce the benefit of paying off the mortgage first.

There are so many variables to consider, it is important that you do your homework well and seek professional advice to match your decision with your personal circumstances. A windfall might be money received without effort on your part, but effort and planning are what you need to get the best from your gift of good fortune.

1. Assumes the property was held for more than 12 months.

BraviumSuite 4, 32 Thesiger Court,
Deakin, ACT 2600**P** 02 6232 4822**E** scott@bravium.com.au**W** www.bravium.com.au

Steve Jobs

Lessons from a life



Steve Jobs always lived life on his own terms, doing what he loved, which was to explore the creative possibilities which computers offered.

Financially, he began with nothing, starting Apple Corp in his parents' garage with a friend, and inventing a new kind of computer which gave birth to a multibillion dollar company. He was then thrown out of his own successful company, humiliated. Despite this, he believed in himself enough to start again and built not one, but two more companies before returning to Apple.

Money was never the driving force in Jobs' life, but he made three fortunes by sticking to the basic values that energised him. So what lessons can we learn from the life of this man?

Lesson 1: Trust your instincts.

Jobs, an adopted child, dropped out of his college course after only six months because he thought it was a waste of his working-class parents' hard earned savings. But although he quit his course, he did not walk away from learning.

He said later that he didn't really know why he hung around college but, aged 17, he spent the next 18 months sleeping on friends' floors while learning things he found interesting.

The reality is that much of what he learned by following his curiosity and intuition turned out to be really useful in later life, subjects like calligraphy and typography. Ten years later, the typographic functions built into the first Apple Macs sparked a revolution in publishing and printing. Jobs said, "If I had never dropped out of college, I would have never dropped in on this calligraphy class, and personal computers might not have the wonderful typography that they do."

Lesson 2: Never give up on yourself.

Apple had grown into a \$2 billion corporation when the board of directors turned on Jobs and shut him out of his own company.

Jobs was devastated, but he slowly realised that he still loved the creativity of computers and he still had his expertise and experience. During the next five years he created an IT company called NeXT. He then bought and developed Pixar which became the world's leading computer animation studio before it was swallowed by the Disney corporation, making Jobs into Disney's largest shareholder. Finally, Apple realised they had lost their way without Jobs, and bought NeXT to get him back on board.

"I didn't see it then," Jobs recalls, "but it turned out that getting fired from Apple was the best thing that could have ever happened to me."

Lesson 3: Do what you love. Love what you do.

Jobs' life reflects his belief that if you love what you do every day, you will achieve happiness and success. "Your time is limited, so don't waste it living someone else's life," Jobs told Stamford University graduates. "Don't be trapped by dogma — which is living with the results of other people's thinking. Don't let the noise of others' opinions drown out your own inner voice. And most important, have the courage to follow your heart and intuition."

We don't have to have the creativity and talent of Steve Jobs, but his story can still inspire each one of us to keep going when things are not working out, to treat setbacks as an opportunity, and to pursue our dreams with hard work and confidence.

When you look at it more closely, Jobs' success was built on a basic principle of successful investing. He always had a goal, even if he wasn't always sure of how things would work out.

Once you know where you want to go, you have a much better chance of getting there.

General Advice Warning: This advice may not be suitable to you because it contains general advice that has not been tailored to your personal circumstances. Please seek personal financial advice prior to acting on this information.

Investment Performance: Past performance is not a reliable guide to future returns as future returns may differ from and be more or less volatile than past returns.

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