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The power of compounding

Compounding isn't a new concept – many of us will remember studying it back in our school days. Legendary scientist Albert Einstein famously called it 'the most powerful force in the universe', while American business magnate John D Rockefeller suggested compounding is the 'eighth wonder of the world'.

These might sound like bold claims, but the power of compounding on an investment portfolio should certainly not be underestimated.

What is compounding?

In simple terms, compounding is the process whereby returns made on an investment are reinvested in order to generate subsequent returns of their own.

The concept of compounding is best illustrated using an example. Twins Annie and Vanessa both allocated $10,000 to the same interest-bearing investment on their 25th birthday. For simplicity, let's assume the investment pays interest of five per cent per year.

Annie reinvests all of her interest every year, while Vanessa banks the $500 each year and spends it on everyday living expenses. Let's see how their investments had fared by their 45th birthday.

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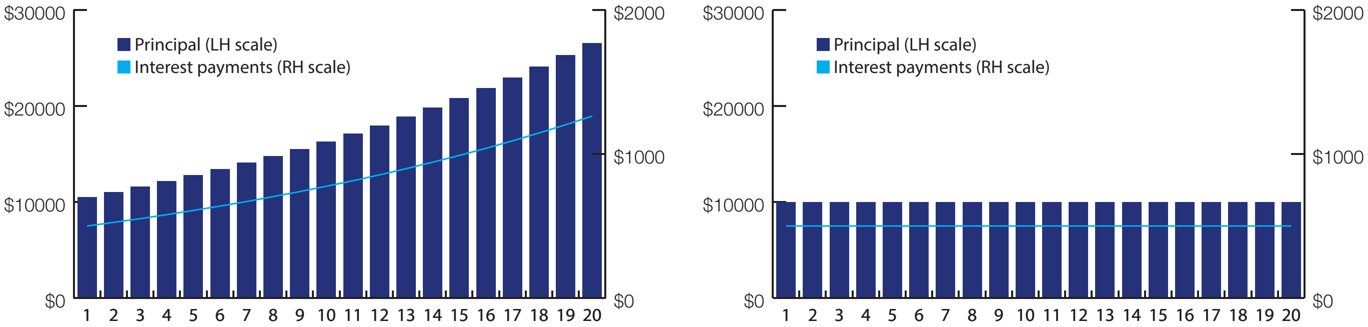
Vanessa earned $500 interest each and every year for the 20 year period – a total of $10,000. Of course she still had her original $10,000 investment as well.

Annie, on the other hand, saw her investment grow to more than $26,000 by reinvesting her interest. The additional $6,000 she earned over and above Vanessa highlights the power of compounding. Annie's investment is now earning her $1,263 per year, while Vanessa's investment is still earning her only $500. This differential would continue to grow over time if the sisters remained invested.

Figure 1: The effect of reinvesting interest

Annie's investment

Vanessa's investment



Source: CFSGAM. Figures used for illustrative purposes only.

Make compounding work even harder for you

The power of compounding can be magnified if you make small regular contributions to your investment. Let's look at another example to highlight the concept.

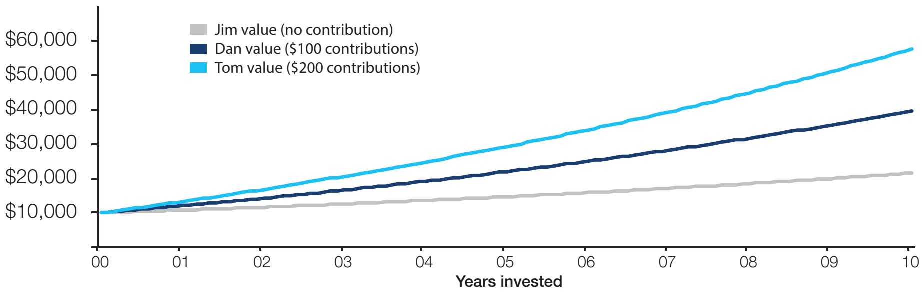
Brothers Jim, Dan and Tom all decided to invest $10,000 in the same managed fund for 10 years. Over that time the fund returned an average of eight per cent per annum.

Happy with his original investment decision, Jim did not make any additional contributions. Dan, the wiser brother, understood the effects of compounding and made additional regular savings of $100 per month. Tom – the wisest of them all – worked out he could afford to save an extra $200 per month and made sure he always contributed that amount to his investment. The difference in their investment returns over 10 years is startling.

Figure 2: Effect of compounding with regular contributions over 10 years

	Initial investment	Monthly contribution	Annual return %pa	Value after 10 years
Jim	$10,000	0	8	$21,589
Dan	$10,000	$100	8	$39,602
Tom	$10,000	$200	8	$57,614

Source: CFSGAM. Figures used for illustrative purposes only.



Source: CFSGAM. Figures used for illustrative purposes only.

Of course the example is a stylised one. It ignores potential fluctuations in investment returns over the period, which would affect the three outcomes in reality.

These examples highlight how compounding and contributing regularly to an investment can have a major influence on investment performance. The long-term performance impact of compounding can be significant and must not be overlooked by investors. Perhaps Einstein and Rockefeller were right, after all.

Speak to your financial planner to see how you could be compounding and contributing regularly to your investment.

Source: Colonial First State, May 2014

Protect yourself against survival

Australians are becoming more educated about their health – whether it's actively pursuing preventative measures or a greater awareness of healthcare options. Combined with improvements in medical technology and clinical practices, there has been a marked decline in death from major health conditions in recent times[1]. For example, the death rate from male cancer over the 20 years to 2007 fell by 16 per cent.

Living longer

We are living longer – and with that comes the increased likelihood you'll experience a major health issue. But survival rates are also on the increase due to medical advancements.

- Cardiovascular disease is the number one cause of death in Australia[2] but has increasing survival rates[3].
- Long-term survival rates among stroke patients has more than doubled since the 1970s[4].

The number of Australians living with long term health issues is also increasing. It's estimated that as many as 1.7 million Australians have undiagnosed 'type 2' diabetes[5]. More than four million Australians are living with some form of disablement[6].

Protecting your financial security

If the unforeseen was to happen to you, how would you protect yourself and your loved ones? Consider the financial impact of absences from work and medical expenses. Without a plan you may struggle to maintain your lifestyle during recovery.

Part of your plan should include considering personal insurance to protect you financially against serious disablement or illness.

Trauma or total and permanent disablement – or both?

Many Australians have some type of insurance cover through their super – but are you sure it will be enough or it will cover you if you suffer a serious health condition and survive?

Trauma and total and permanent disablement (TPD) cover will pay you a lump sum benefit which will assist in improving the quality of your life. Importantly, it gives you choices – treatment and rehabilitation, future employment options, home modifications. Each one is unique to your circumstances.

Trauma cover pays a lump sum if you suffer a serious health condition or trauma event such as a heart attack or cancer. Trauma cover provides the financial assistance you need so you can focus on your recovery. It is worth noting that trauma cover is not usually available through your super fund so this type of cover is definitely worth considering.

If you were to become totally and permanently disabled and were unable to work again, then payment of a TPD benefit would provide financial relief. TPD covers illnesses and injuries that are not usually covered under trauma cover. The lump sum can be used to meet immediate expenses and payment of debt and can also be structured to provide an income for you and your family over the long term. If you do have TPD cover in your super, you'll need to assess whether it's enough?

Make sure you get the most appropriate amount of cover

The consideration is usually less about which cover is right for you but how much of each type of cover you need. At such a stressful time, the last thing you want to think about is money issues. Personal insurance is an effective way to protect you and your loved ones from the financial distress that many illnesses can cause.

Speak to your financial planner, so that you can get the help you need to protect your financial security.

Source: AIA Australia, May 2014

1. AIHW – Australia's health: In brief (2010)
2. Australian Bureau of Statistics (2008 – 2011)
3. AIHW – Cardiovascular disease mortality: Trends at different ages (2010)
3. Stroke society of Australasia (2011)
5. Diabetes Australia (2011)
6. Australian Bureau of Statistic (2009)

Making the most of your retirement income

Retirement is a life-changing event. After you stop working, you can find yourself with time to do the things you may not have been able to do before, like travelling, volunteering or spending more time with family and friends.

As you adjust to this new lifestyle, you'll also need to think differently about your finances. In retirement, your priority typically changes from saving, in preparation for when you leave the workforce, to carefully spending those hard-earned savings. It's likely that your initial focus will be to find a way to replace your salary or wage with cash flow from other sources.

The composition of your retirement income requires careful planning. Your retirement income may come from more than one source.

Age pension

The age pension is an income support payment offered by the Government to older Australians who meet the relevant eligibility criteria.

With maximum payments of $21,912.80 per annum for a single pensioner and $33,035.60 per annum for pensioner couples (including the pension and clean energy supplement and current for the period 20 March 2014 to 19 September 2014), the age pension probably won't be enough to afford most people a modest post-work lifestyle of basic activities, let alone a comfortable lifestyle.

To afford even a modest lifestyle in retirement, many people will need to supplement the age pension with other income. This could come from an annuity, an account-based pension or other investments.

An annuity (from within or outside super)

An annuity is a simple, secure financial product that guarantees a series of payments, for a fixed term or for life, in return for an upfront investment. The earning rate is fixed at the outset, and this applies for the length of the annuity, regardless of share market movements or interest rate fluctuations. Capital can be returned at the end of the agreed term or gradually during the term of the annuity as part of the regular payments.

An account-based pension (from your super)

An account-based pension is an investment account which gives you the ability to choose from a range of investments and can vary from time-to-time with the level of income you wish to draw subject to the minimum annual pension payment set by the Government. Account-based pensions are usually market linked. This means that the capital value is linked to the performance of the underlying investments, which can impact the level and duration of your savings and the income produced. Account-based pension providers, which may include your super fund, charge management and/or administration fees for these products. This reduces your investment returns.

Other investments

These are just some of the types of investments that can sit within your super fund (personal or self-managed superannuation fund) or outside superannuation.

- Term deposits are fixed term, fixed interest savings account. Terms generally range from one month to five years.
- Shares pay income in the form of dividends. You can invest in shares directly or via managed funds.
- An investment property is real estate which has been purchased with the intention of earning a return on the investment, either through rent, the future resale of the property, or both. Another type of property investment is a property trust, which is a managed fund that enables investors to pool their money to purchase an interest in a portfolio of real estate assets.

Income from various sources can be 'layered' to meet your income requirements. This can be set up so that more secure income, such as from the age pension or an annuity, can cover your essential costs of living, while your income from other sources can fund your discretionary spending.

This approach can also allow your more growth-oriented assets to remain invested, giving them time to grow.

Source: Challenger, May 2014

Since each person is different, there is no single retirement income solution. More than one investment strategy and product may be required so it's important you receive professional help from your financial planner. It can make all the difference to your financial success in retirement.

Economic outlook

We take a look at major developed economies and their economic growth to consider for your investment strategy.

US

Key considerations for fixed income investing

The Federal Reserve has continued to partially remove stimulus via further reductions in quantitative easing (QE) this year. Despite this reduction, US 10 year treasury yields have fallen from 3.0 per cent in January to approximately 2.5 per cent. We are not particularly concerned about the risk of inflation, which is usually the key driver of higher interest rates. There is too much excess capacity and structural unemployment in the global economy (especially in Europe) for us to be overly concerned of an inflation spike. However, The US Federal Reserve owns close to 35 per cent of all US Treasuries with more than five years of duration remaining. There is a risk that rates could rise with the removal of Federal Reserve buying. As a result, we recommend investors allocate a significant proportion of their defensive assets to credit funds with minimal duration exposure, to reduce the risk of loss of capital if US 10 year government bond yields do indeed rise significantly.

Will stronger GDP growth lead to strong earnings growth and market gains?

Despite slow growth in the first quarter which was largely weather related, we believe US GDP growth in 2014 is likely to be in the vicinity of 2.5 – 3.0 per cent, which is higher than the growth rates of 2013. Importantly, public sector revenues have improved due to stronger consumption and higher asset prices, which has led to higher tax receipts. The budget deficit is likely to decline to 3.0 to 4.0 per cent of GDP, negating the need for major expenditure reductions or tax increases. The outlook for corporate capital expenditure is positive, and consumer confidence is robust due to recent gains in housing and equity prices as well as employment growth.

While the outlook for US GDP growth is reasonably positive, the outlook for corporate earnings is not particularly promising. First quarter earnings grew at close to 2.0 per cent, and we are doubtful that consensus expectations for 8.0 per cent earnings growth this year will be achieved. Tailwinds of reduced interest expenses, no real wages growth, productivity gains and US dollar weakness have been key drivers of US corporate margin expansion in recent years. A number of these earnings tailwinds have abated. Corporate margins may hover at their current historically high levels, but further margin expansion is unlikely to be significant. The US dollar has strengthened against most major foreign currencies over the past year, which is a headwind for earnings growth (earnings from subsidiaries are worth less in US dollar terms and exports priced in local currencies are also worth less in US dollar terms). Interest rates are likely to gradually increase in the years ahead, providing a further headwind to earnings per share growth. The consequences of this is not necessarily poor share market performance – but further price earnings multiple expansion is likely to be a prerequisite for any further share market appreciation of considerable magnitude.

Europe

Expect slow growth and diversity in GDP growth rates

We expect Europe to exhibit slow, albeit positive GDP growth throughout 2014. Business and consumer confidence have improved, and this could lead to more robust business and consumer spending. The medium term inflation outlook in Europe is low, and is likely to fluctuate around 1.0 per cent or less. Given the very high unemployment rate of close to 12 per cent (with significant disparity between countries), and low workforce participation rates, wage inflation pressures are minimal. The output gap is also wide in Europe, with significant excess capacity. As such, with nominal GDP likely to grow at about 2.0 per cent, European nations are less able to inflate their way out of their high net debt levels.

Banks remain in deleveraging mode, and credit conditions remain relatively tight. Growth rates between European nations are likely to remain varied – Germany is likely to exhibit more positive growth, with Spain and Italy continuing to lag.

The outlook for UK GDP growth is more promising – consumer spending is growing and business investment has finally started to exhibit some robustness. Inflation is also higher, equating to significantly higher nominal GDP growth than continental Europe.

Japan

Japan is likely to experience slower growth this year, mainly due to the sales tax increase in April 2014 from 5.0 to 8.0 per cent, which is likely to dampen consumption, and also due to more constrained government expenditure post extraordinary stimulus in 2013. GDP growth is likely to be in the vicinity of only 1.0 per cent.

Source: IOOF, May 2014

Be prepared, understanding the aged care reforms

The 'Living longer, living better' aged care reforms, which were announced in April 2012, are scheduled to begin on 1 July 2014. Full details are at www.livinglongerlivingbetter.gov.au. It is important to note that, as existing residents will be grandfathered under the current rules, the new rules will only apply to individuals who enter residential aged care on or after 1 July 2014.

Aged care changes in brief

Major changes are summarised in the table below.

	Before 1 July 2014	From 1 July 2014
Aged Care Assessment Team (ACAT)	ACAT assessments distinguish between high or low care.	No distinction between high and low-level care. ACAT will assess all forms of care.
Upfront accommodation costs	Two options: 1. Lump-sum accommodation bond for low-level care or an extra service facility. 2. Daily ongoing accommodation charge for high-level care. Costs determined by assessable assets.	Costs known as: ■ RADs (refundable accommodation deposits), and ■ DAPs (daily accommodation payments). Residents have 28 days on entering a facility to decide payment method. (Costs determined by a resident's assessable income and assets.) Facility costs are more transparent (published at www.myagedcare.com.au).
Retention amounts	For accommodation bonds, a facility may deduct a 'retention amount' each month for up to five years.	Amounts no longer to be deducted from RADs.
Ongoing care fees	Fees include: ■ Basic daily fee – all residents. ■ Income-tested fee – Not payable by full pensioners and determined by assessable income (maximum applies). ■ Extra service fee – set by extra service facility.	Fees include: ■ Basic daily fee – all residents. ■ Means-tested care fee – determined by assessable income and assets (no daily maximum but yearly and lifetime caps apply). ■ Extra service fee – facilities can offer extra services for fee.
Home assessment	Home not assessed for income-tested fee.	For the purposes of paying a RAD or DAP, the full value of the home is included as an asset, unless an eligible person (such as a spouse) remains in the home. However, for means tested care fee purposes, the assessable value of the home is capped – up to a maximum of $144,500 (indexed to approximately $153,905 in July 2014).

Here are three guiding principles to help navigate the changes.

Principle #1 – aged care is about more than numbers

Aged care is not a purely technical prospect. First and foremost it is an emotional dilemma. In our experience, when advising families, it is rare that everyone agrees on everything – from the standard of the facility through to geographic location or the type of care.

In terms of financial strategies, there is no 'one-size-fits-all' solution. You will need to compare multiple strategies before reaching a decision. One of the difficulties that can occur is that decisions made by family members can sometimes be in their own best interest and have little to do with what's best for the prospective resident. It can often take time and the intervention of professional advice to get the best result for both the family members and the prospective resident.

Principle #2 – get good advice

It is important to find a financial planner that is up-to-date regarding aged care and Centrelink rules. This should include an understanding of aged care and social security regulations, as well as entitlements for veterans and the overlay of taxation, superannuation, and retirement income streams.

Principle #3 – for better or worse, make the most of the rules

As we approach 30 June 2014, we are often asked whether residents will be better off under the new rules or whether they should bring forward plans to move into aged care.

In modelling the application of the income-tested fee under the current rules and the application of the means-tested fee post-30 June 2014, the cost of care will generally be more expensive under the new regime. The annual and lifetime capping of the means tested fee will make it more affordable for some people, particularly those who are generally healthier and have greater personal wealth.

The set of financial strategies available under the new rules also presents some opportunity. By way of example, since only a portion of the principal residence will be assessed (if not occupied by a protected person), there may be more reason than under the current regime to retain the principal residence.

Source: Australian Unity, 2014

Contact your financial planner today to see how you can become ready for these changes

Countdown to the end of the financial year

Get your financial affairs organised and ready for the 30 June deadline.

Some key things to include:

Super contributions

Look at increasing your contributions to super, so you can save more for retirement and benefit from some tax concessions. For instance did you know that:

- if you are employed, you could make super contributions from your pre-tax salary
- if you are self-employed, you could get a tax deduction for the money you put into super
- if you contribute after-tax pay or savings into super, you may pay less tax on investment earnings, qualify for a super contribution from the Government or receive a tax offset.

Beware though of the contribution limits as you might be subject to additional tax and charges if you exceed them.

Interest on investment loans

Prepaying interest on an investment loan before 30 June may give you a potential tax saving, due to the tax deduction being brought forward.

Payment of insurance premiums

You may be eligible to claim a tax deduction this financial year if you take out an income protection policy outside of your super account before 30 June.

Offsetting capital gains tax

You can reduce the amount of capital gains tax you have to pay by making tax deductible contributions to super (if you are eligible).

Life after work

Speak to your financial planner about how to structure your financial assets in the most tax-effective way that allows you to maximise your income-generating capability in retirement.

Right level of cover

Some insurance benefits will not be available through your super fund from 1 July 2014. So to ensure you have the right cover in place, speak to your financial planner.

Source: MLC, May 2014

The benefits of a low and high Australian dollar

The Australian dollar has been accused of inflicting all sorts of economic ills as it traded above US$1 for most of the past three years.

People would be forgiven then for thinking that the dollar's drop from its post-float record high of US$1.10 in 2011 to below 90 US cents will be a big relief. Alas, it's not so simple. As with most things economic, there are pluses and minuses whatever the value of the Australian dollar. Those who whinged about the "overvalued" Australian dollar crushing exports overlooked its benefits. They may well be the ones who moan loudest about a falling dollar. One upshot of a declining dollar is that it reinforces one of the most basic principles of investing – diversification.

There are two main benefits of a mighty dollar. The first is that a higher currency, in effect, means that every Australian has had a pay rise. For a stronger dollar allows us to buy more imports. This is the mechanism by which all Australians benefited from the mining boom. The second benefit is that a rising currency reduces inflationary pressures as the prices of imports decline in Australian dollars. That allows the Reserve Bank of Australia to set interest rates at a lower level than otherwise.

In theory, a lower dollar helps Australian exporters (and adds to output) because our goods are cheaper for foreigners. This is the break exporters have been pleading for, even if in practice exporting is more complicated than just hoping the currency drops a bit.

We may not want our dollar to fall too far too fast, however, as side effects emerge. These disadvantages are, in fact, the opposite of the advantages of a rising dollar. Inflation could emerge as a threat if the dollar slumps too much. That would mean higher interest rates. Ouch for those with home loans. Some businesses might scrap plans to invest, thus lowering employment prospects.

Bad as that might be for many, the big hit for all of us from a lower dollar is that we have effectively just had a pay cut as import prices go up.

This hit to living standards from a declining Australian dollar forms one of the most basic cases for why Australians should invest in foreign assets such as shares. If your portfolio only holds Australian assets, your ability to purchase imports drops in line with the dollar's decline. If you own some foreign assets, however, the value of these foreign investments rises in Australian-dollar terms when our dollar drops. This mechanism compensates, to some extent, for your reduced ability to buy imports. In more technical terms, it's called diversifying currency risk.

Source: Fidelity, May 2014

Financial information comes from Bloomberg unless stated otherwise.

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