Financial Focus

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Welcome to Financial Focus, the newsletter that provides you with the latest news and information on significant financial planning topics. I hope you find the articles in this issue interesting and informative. If you have any comments, questions, or would like a review of your financial plan, please call me.

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A new dawn for income investing

Income focused investment strategies have increased in popularity over the past few years as some investors shy away from the higher volatility of traditional investments like shares.

So what's income based investing all about and how do you make the most of this approach to investing?

Short term solution

The objective of income based investing is to deliver a stable and sufficient income stream while at the same time reducing underlying capital volatility.

On the surface, simply shifting into cash and fixed income based strategies aims to achieve this. With term deposits and fixed income funds having delivered returns of 7% to 10% or higher with negligible capital volatility, it seems to be a perfect solution to the problem.

If such returns could be sustained long term, then this could be a reasonable investment solution.

Unfortunately, it's highly unlikely that cash and fixed income based investments alone will generate this level of returns on a sustainable basis in future.

Average term deposit rates have fallen below 6% following interest rate cuts by the Reserve Bank of Australia and bond funds are seeing much lower yields at the moment.

This suggests future returns from these strategies on average are likely to be markedly lower over coming years.

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In search of higher yields

However cash and bond strategies are just one element of income focused investing.

The Australian sharemarket also contains higher dividend paying share investments.

Apart from a higher potential after-tax return, the benefit of a dividend focused strategy is that dividends tend to grow over time in line with corporate profitability. This growth provides some protection against rising cost pressures.

The potential dividend returns available from investing in the local share market are also relatively quite attractive, provided profits are sustained. The average dividend yield of the

Australian share market was almost 5% pa at the start of 2012.

Add on the after tax franking benefits available to retirees then this might be boosted a further 1.5% to 2%.

Even more appealing, the higher yielding sectors of the local market are offering dividend yields around 7% to 8% pa or higher at present. Add in franking credits and the after-tax yield rises to closer to 9-10% pa.

Provided dividends can be sustained and grown over the long term, then the yields on offer in Australian share market would seem to meet many investors' needs.

Balancing yield with volatility

However, there's a potential sting in the tail with this strategy. While some of the higher yielding parts of the Australian share market have also been relatively less volatile capital investments, the Australian banks, for instance, displayed significant capital volatility in 2011 despite their high yield.

For investors who want higher yields with lower risk, this high volatility could be a problem.

So is it possible to develop strategies that combine higher, more predictable, income returns, with lower capital risk on a sustainable basis?

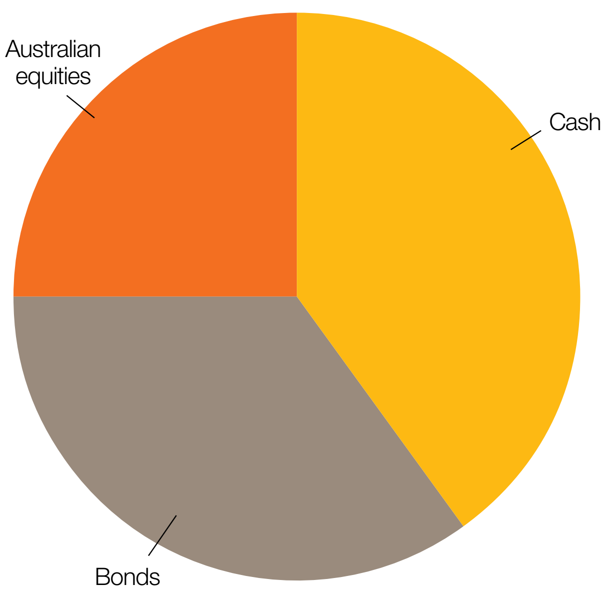
Blending for balance

There are solutions to this, but they're likely to require more sophisticated approaches. Blending a range of investment strategies that deliver sustainable income returns while actively managing capital risk could be an answer.

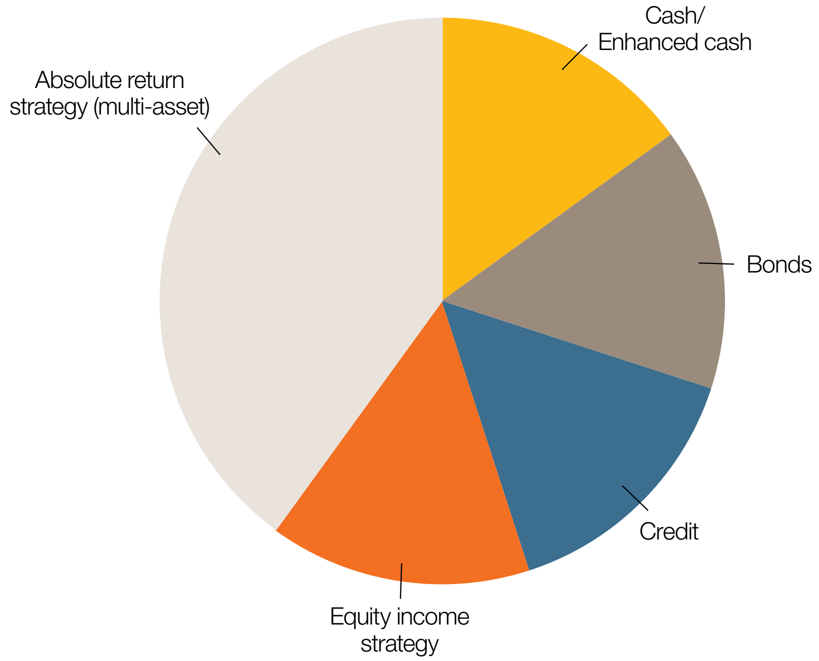
Such strategies are likely to employ various combinations of cash and bond based investments with dividend focused share investments as well as other income producing strategies such as international shares, credit, absolute return and equity income strategies. This helps maximise the diversity of sources of return as well as minimise investment risk.

If you would like to discuss an income investment strategy, talk to your financial planner who can work out the best approach for your needs.

Simple income approach



Sophisticated income approach



Source: MLC Investment Management. The absolute return strategy may also hold allocations to cash, bonds and credit assets. Note that this is a stylistic representation of a more diversified income solution. Speak to your financial planner about the most appropriate investment mix for your needs.

Secrets of the world's best investors

The world's best investors have developed a number of highly successful investment strategies in decades past. Some of these investors started out with as little as $100 and today boast fortunes worth billions.

We thought we'd take a look at the lessons from three of the world's most successful investors and see how they can be put into practice.

1. Warren Buffett

It's fair to say that Warren Buffett was born to invest. Known as 'The Oracle of Omaha', after the Nebraskan city where he was born, Buffet is one of the best known names in the investment world today. He started out with just US$100 to invest in 1954, and today he is worth $39 billion. His company, Berkshire Hathaway, has $372 billion in assets.

Lesson: "Be fearful when others are greedy and greedy only when others are fearful."[1]

Many people start investing when there's a lot of hype around markets going up. This usually coincides with investments being overvalued and possibly at all-time highs.

On the flip side, investors often sell investments when there's talk of markets falling. This is usually when those investments are undervalued, because everyone else is also offloading them. Both of these are not clever approaches to building wealth.

Buffet learned over the years that the only way you can really make the most of your investments is to have consistent exposure to the markets, so that you're buying low and selling high during all market cycles.

2. John Templeton

At the start of World War II when investors were bailing out of investment markets, Templeton knew he had to 'be in it to win it'. He sank US$10,000 into undervalued companies across the board, and four years later this approach netted him more than $40,000.

Lesson: "The best time to invest is when you have money. This is because history suggests it's not timing which matters, it's time."[2]

Templeton's lesson highlights why dollar-cost averaging is so powerful. This strategy, where money is invested into the market at regular intervals, means you avoid the (potentially ill-fated) temptation to time the market.

The good news is that the superannuation system effectively does this for you. The nature of regularly contributing to super means you're drip-feeding your investments into the market regularly and over a long period of time.

A key advantage of this is that when markets are weak, like they are now, you're buying more units for your dollar. And when they're strong, you're resisting the temptation to buy more when prices may be overvalued.

3. Bill Gross

Considered the world's leading bond fund manager (he's called the "king of bonds") Gross is an expert in spreading risk, calculating odds and diversifying opportunities. He is the founder and managing director of the Pacific Investment Management Company (commonly called PIMCO), which manages more than US$1.35 trillion in assets for investors and institutions worldwide, including MLC.

Lesson: "Diversify, but don't diversify yourself so much you're left with portfolio mush."[3]

Gross is a big believer in intelligent diversification. Even if investors really like a particular investment option, he recommends they put a maximum of 10% or so of the money they have to invest into it to minimise the risk. That said, he doesn't believe in diversifying for diversity's sake; rather he advocates investing selectively to get the best returns.

If you'd like to more information on managing your investments, speak to your financial planner.

1 Source: Berkshire Hathaway 2004 Chairman's Letter

2 Source: Mark Mobius, Executive Chairman, Templeton Asset Management, quoted on iStockAnalyst, courtesy of Bloomberg, 2 September 2011.

3 Bill Gross, Bill Gross on Investing, John Wiley & Sons, 1998.

Financial health check for over 50s

If you're aged 50 or over, some changes are on the horizon this year that could impact your retirement plans. Without good strategic advice, you could miss some significant opportunities or incur higher tax bills.

Here's a rundown of what's happening and how it could affect you.

What's happening?

The cap that applies to concessionally taxed super contributions is scheduled to reduce from $50,000 to $25,000 pa on 1 July for people aged 50 or over.

However, there's still some uncertainty around this legislation. The Government recently announced that it will discuss retaining the cap at $50,000 pa for people age 50 or over, but only for those with less than $500,000 in super.

Whichever way the legislation goes, this change could have significant implications for super investors in this age group.

The concessional contribution cap applies to employer contributions (such as superannuation guarantee contributions and contributions made under a salary sacrifice arrangement) as well as personal contributions claimed as a tax deduction.

Should you do anything before 1 July?

If you think you'll be affected by the change, you may want to make the most of the higher cap this financial year by making concessional contributions of up to $50,000 before 30 June. After that date, it's important to review your contributions with your planner and reduce them if necessary.

If you exceed the cap, you could end up paying excess contributions tax of 31.5%.

What if you're not impacted by a lower cap?

Even if you are not impacted by a reduced cap from 1 July, it's still important to be aware of the consequences of contributing too much to super.

Since the contribution caps were introduced five years ago, the Australian Taxation Office has issued 65,000 people with excess contributions tax bills totalling approximately $400 million.

While super is still a very tax-effective place to save for retirement, the benefits can be unwound if you put in too much.

Your financial planner can look at your current cashflow position, how long you have until you plan to retire and a range of other factors. They can then help you identify a contribution plan that maximises the benefits of super without triggering tax penalties.

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