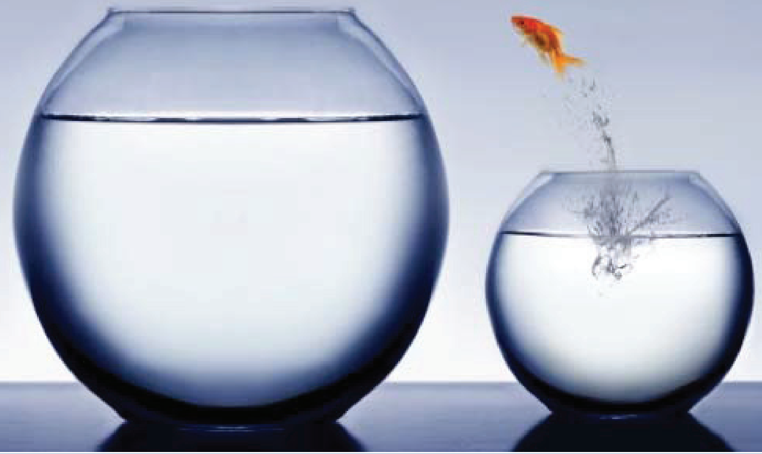
Personal Wealth



Autumn 2015

A Quarterly Newsletter for **Lifespan Clients**

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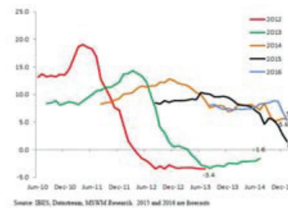


How we build investment portfolios

SMSF ADVICE CERTIFICATES

A potential roadblock for SMSF property investors.

A certificate of advice, required by lenders prior to settlement, has proven to be a major sticking point for clients looking to borrow and invest in property within a self-managed super fund (SMSF).

The certificate, which is issued along with the loan contracts, is required to confirm the borrower has received appropriate advice relating to the SMSF purchase from a financial adviser or accountant. The advice certificate asks the adviser or accountant to confirm that the borrower has been provided advice about: the suitability of the loan, the ability for repayments to be made, the associated risks, the impact and the general terms of the loan.

Signing off on the certificate requires that a financial adviser/accountant has a comprehensive understanding of the borrowers' financial position. Therefore the process can be time consuming with the adviser holding the responsibility to give appropriate advice.

Roadblocks can emerge as the certificate may not be discussed or requested by lenders until late in the purchase period, which may not leave adequate time for it to be completed. This has lead to delays in settlement, penalty interest being charged, and in the worst cases, loss of property and deposit.

Advice certificates can also vary between lenders, so it's important that advisers/accountants have the opportunity to inspect the certificate prior to the borrower committing to an application. This can help minimise unnecessary delays during the purchase process. Certificates can be requested from lenders by prospective borrowers prior to the

A recent case that highlights the stress and pressure that lack of awareness of advice certificates can present for borrowers, involves an investor who contacted our office for advice in a panic.

The client had gone direct to the bank to purchase commercial property through their SMSF.

Unfortunately the banking consultant processing her transaction made the common mistake of not making the client aware of the advice certificate requirement.

Contracts were then issued over the Christmas period, and the borrowers' adviser was on leave and unreachable. Without an advisor or accountant willing to sign off on the certificate, the bank refused to proceed and the client missed the initial settlement date.

The client was consequently charged penalty interest by the vendor on a daily basis until it was finalised. In the end the bank's lack of disclosure cost the client almost **$10,000** in additional penalty fees.

SMSF application commencing.

Some certificates require the adviser to sign off on the suitability of a specific loan product. Loan products do not usually fall within the scope of financial planning and are not covered by the adviser's licence, therefore making it impossible for the adviser to comment on let alone confirm its suitability for the client.

There is, however, some light at the end of the tunnel for borrowers looking to purchase residential property through their SMSF. There are now some lenders that have abandoned the financial advice certificate, replacing it with a 'Trustee Acknowledgement' letter. This ends the need for a certificate to be signed off by an adviser/accountant and shifts the accountability of the financial decisions to the borrower. However not all lenders have made this move, so to be sure talk to your mortgage broker or lender to confirm.

Purchasing property through the SMSF can be a little more complex than your everyday purchase, but it doesn't need to be more stressful! Having awareness of all requirements from the beginning can make for a more efficient, seamless purchase.

Investment Markets

Recent History

After a period of low volatility, the Australian Equity market (ASX200) twice fell to about the 5,100 level late in 2014 before recovering again. Global equity markets also took a dip before rebounding.

For the last quarter of 2014, the Australian share market returned 3.1% while Australian Small Cap Equities underperformed with a negative return of -3.9%.

For 2014 Australian shares had a modest return of 5.61% while Australian Small Cap Equities had a negative return of -3.81% after a bad last quarter.

The Australian dollar continued its downward trajectory during the quarter, falling from 87.5 cents to 81.8 cents versus the US dollar.

The falling Australian dollar contributed to the performance of Developed Market global shares which returned 7.4% for the quarter while Emerging Market equities returned 2.2%. For the whole of 2014 Developed Market global shares returned 13.87%, easily outperforming Australian shares.

Falling Australian bond yields resulted in a return of 3.96% for the fixed interest benchmark for the quarter while Cash returned just 0.69%. For 2014, Australian fixed interest returned 9.81% which was well above the return for Australian shares.

Falling bond yields also contributed to the outperformance of the higher yielding sectors with Listed Australian Property returning 11.5% for the quarter and 27.0% for the year. Global bond yields have been falling to historic lows even after the end of US quantitative easing (QE).

The quarter also saw a continuation of the dramatic fall in the price of a number of commodities such as iron ore and oil in particular which traded at multi-year lows.

The Reserve Bank of Australia (RBA) lowered the cash rate by 0.25% to 2.25%, the first move since August 2013 which resulted in a big rally in Australian shares.

Markets and Economy

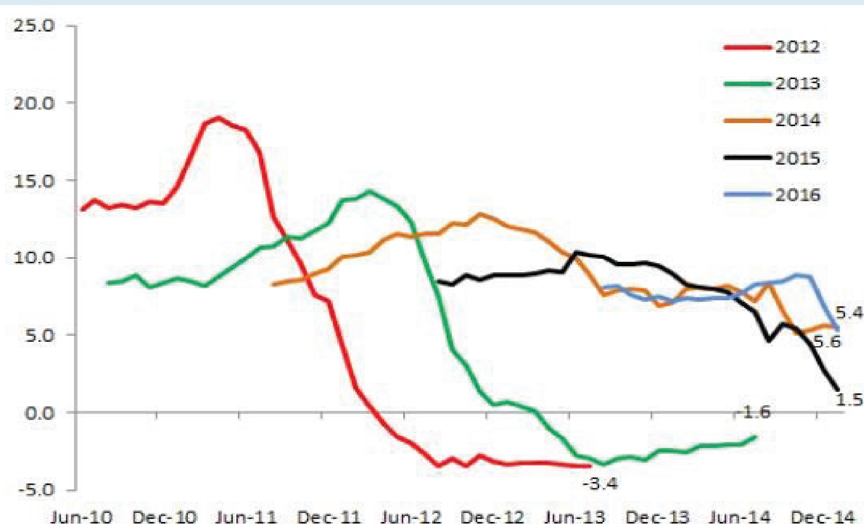
Global growth rates have continued to miss expectations over the last few years. The World Bank has again cut its forecast for global growth in 2015 with a forecast for global GDP growth of 3.0% this year, down from a 3.2% prediction in October.

Australian GDP grew 0.3% in the third quarter of 2014, down from the 0.5% expansion reported in the previous three month period and below the market's expectations.

China has reacted to weaker than expected economic data by easing policy including a 0.4% interest rate cut, the first one in over 2 years. The global bright spot is the USA where GDP increased at an annual rate of 2.6% in the fourth quarter of 2014 after readings of 5.0% in the third quarter of 2014 and 4.6% in the second quarter. Also the unemployment rate declined to 5.6% in December 2014, the lowest since June of 2008.

Eurozone GDP growth was just 0.2% in the third quarter of 2014 while inflation has drifted to very low levels with headline inflation coming in at -0.6% in January 2015. While the Core inflation rate is higher at about 0.6%, this is still very low and the European Central Bank (ECB)

Chart 1: Australian (ASX 200) EPS Growth 2012 - 2016



Source: IBES, Datastream, MSWM Research. 2015 and 2016 are forecast.

considers anything below 1% to be in its deflation danger zone.

These factors have resulted in historically low bond yields with the German 10-year bond trading at 0.35% which is lower than even that of Japan at 0.37%. In response, the ECB has finally announced a QE program totaling 1.1 trillion euros.

The major concern in markets right now is about deflation risk rather than a lack of growth. The Organization for Economic Cooperation and Development (OECD) said the annual rate of inflation of its 34 members fell to 1.1% in December from 1.5% in November 2014, the lowest level since October 2009.

A large factor for this is lower energy prices. According to the OECD, 13 member countries experienced a decline in prices over the year to December 2015, only one of which wasn't European. However excluding food and energy, the "core" rate of inflation across the OECD was unchanged at 1.8%.

Also across the Group of 20 largest economies the annual rate of inflation rose to 2.5% from 2.4% in November (WST: Feb 3, 2015).

Outlook

In lowering the cash rate, the RBA said that growth is continuing at a below-trend pace and that the economy is likely to be operating with a degree of spare capacity for some time yet. Currently the market believes we will likely get another cut to 2.0% this year.

Interest rates are at historic lows across the world and unless we are entering a deflationary spiral, bond yields are simply too low and do not compensate you for the risks involved.

We do not believe that an Australian 10 year government bond yield of about 2.4% reflects economic fundamentals in Australia but rather is being driven by desperate yield hungry overseas investors. The same argument applies to US interest rates only more so with that economy performing better than Australia.

We are of the view that that yields are too low and are not attractive long term. Given this, we would still maintain an underweight to fixed interest, particularly global bonds.

We continue to prefer equities to bonds but equities are no longer cheap. Shares in Australia are trading at over 15.3 times next year's earnings estimates which is about one PE point above their long term average.

Also downgrades to earnings forecasts, mainly due to lower commodities prices have resulted in almost no earnings growth for this year (chart 1). In the USA, at the start of 2015, shares were trading on a PE of 16.2 times which is above the 25 year average PE of 15.5 times.

Even Europe with all its issues is trading at 14.1 times earnings against a long term average PE of 14.1 times (JP Morgan), although admittedly off somewhat depressed earnings.

The bottom line is that we have less conviction about investment markets than we did last year on valuation grounds. Global equities received a boost from the falling Australian dollar last year.

While we think chances are that the Australian dollar will fall further we think the fall will be less than last year. Also the higher yielding sectors such as listed property and infrastructure have been driven higher by the relentless chase for yield, with Australian listed property up by 34% in price (excluding dividends) in the year to 3 February 2015.

We would expect more volatility this year than in the recent past, and given the rally in most markets we would not be aggressive in allocating to either fixed interest and equities right now. Going forward we would be more opportunistic and look to take advantage of the higher volatility that we expect in markets. Thus we would advocate a strategy of dollar cost averaging or buying the dips for investors looking to put new money to work .

Chart 2: Investment Returns to 31 December 2014 (% p.a.)

Asset Class	1 month	3 months	1 Year	3 Years	5 Years
Australian Shares	2.06	3.11	5.61	15.14	6.76
Global Shares	2.28	7.37	13.87	23.00	11.25
Listed Property	4.50	11.51	27.04	21.86	12.17
Fixed Interest	1.53	3.96	9.81	6.45	7.33

Source: Mercer

Building Investment Portfolios

Diversification is the key

A key feature of a well constructed portfolio is its diversification. We all understand that this means that you don't put all your eggs in one basket, but we pay much more attention to how a portfolio should be properly diversified to achieve the best outcomes.

Diversification allows for two powerful benefits.

1. The first is risk management. Well diversified portfolios are less volatile than concentrated portfolios. So the chance of losing money from a single bad investment, is substantially reduced.

2. The second benefit comes in the form of additional returns. We won't go into the mathematics behind this process now, but Investment Theory explains that under the right conditions, a properly diversified portfolio will outperform a homogenous one.

We therefore apply this structured approach to diversification to achieve the best results.

This structured approach involves numerous different kinds of investment diversification:

- Diversification across different Asset Classes (such as shares, property, cash, etc.);
- Diversification across Sub Asset Classes (e.g. industrial shares, mining shares, banking shares, etc.);
- Diversification across underlying investments within each asset class, ;
- Diversification across Investment Managers (where the recognised leaders are chosen for their skills at regular market out performance);
- Diversification across Management Styles, such as "Value" and "Growth" managers or "Bottom Up" and "Top Down" managers.

For further information, please consult your Lifespan adviser.

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