On The Horizon

HORIZON WEALTH MANAGEMENT

Helping you achieve financial independence

Edition: Summer 2007

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Welcome to our latest Newsletter. We will try and continue to retain our underlying theme and that is to ensure that the content is relevant, topical and brief. Should you need further information please do not hesitate to contact our office on 02 9392 8700. We will gladly provide you with further details.

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Investment Fundamentals - After Tax Returns

A wise man once said: **"Good investment returns are one thing, but what really matters is how much of that you get to keep."**

This is an observation that you might like to keep in mind when bombarded with fund managers' performance tables.

Investment management in Australia traditionally has been carried out on a pre-tax basis. And the performance tables produced by asset consultants are based on returns before the taxman takes his share.

This contrasts with the United States, where for the past five years, after-tax reporting has been mandatory. The US Securities and Exchange Commission issued a ruling in 2001 that all mutual funds disclose standardised post-tax returns.

While no such law exists in Australia as yet, the tide is slowly turning. In August this year, fund manager MLC joined index manager Vanguard and structured asset class manager Dimensional Fund Advisors in reporting after-tax investment returns.

And research group Morningstar has just increased the level of transparency for individual investors by introducing a long-awaited post-tax performance ranking.

Why does all this matter? Simply because research shows there is **a huge difference in returns between fund managers who deploy tax-aware strategies and those who do not.** A US study showed that when measured on an after-tax basis, **tax aware strategies outperformed tax unaware strategies by more than two percentage points per year.**[1]

"Managers that incorporate the impact of taxes into their investment processes significantly improve the wealth of their investors relative to managers that do not," Ian Heddle of the Investment Technology Group wrote in a recent paper.[2]

As a general rule, improving post-tax returns is harder for active managers, who can turn over 100-200 per cent of their portfolios within a single year. This degree of churn robs members of the concession which allows managers to discount gains by 50 per cent on shares held for longer than 12 months.

By contrast, a fund manager like Dimensional — free of having to seek to beat the equity market through stock-picking and attempting to time the cycle - can concentrate on adding value through portfolio engineering and trading.

It is important to remember that the focus should not be on trying to minimise tax. **It should be on trying to maximise after-tax returns.**

[1]Apelfeld, Roberto; Gordon B.Fowler, Jr, and James P.Gordon, Jr. "Tax Aware Equity Investing", Journal of Portfolio Management, Winter, 1996

[2]Ian Heddle, "A Quick Guide to Tax Efficient Investment (for Australian Markets)", ITG, November, 2005

Window of Opportunity – expiry date 30 June 2007

We would like to bring to your attention the Government's plan to simplify and streamline Superannuation, which was first announced in May 2006. Although the legislation is in draft form **it is expected to take effect from 1 July 2007.**

The key areas that we wish to draw your attention to are as follows.

1. As a transitional measure, you may make an **Undeducted Contribution** (post tax) of up to **$1 million** into your superannuation for the period starting **from 10 May 2006 to 30 June 2007**. If you are aged between 65 and 74, you would need to meet the work test.
2. **From 1 July 2007**, you may make an **Undeducted Contribution** (post tax) of **$150,000 pa** into your superannuation if you are under age 65. You may also bring forward the next 2 years limit and **contribute a lump sum of $450,000 in one year.**

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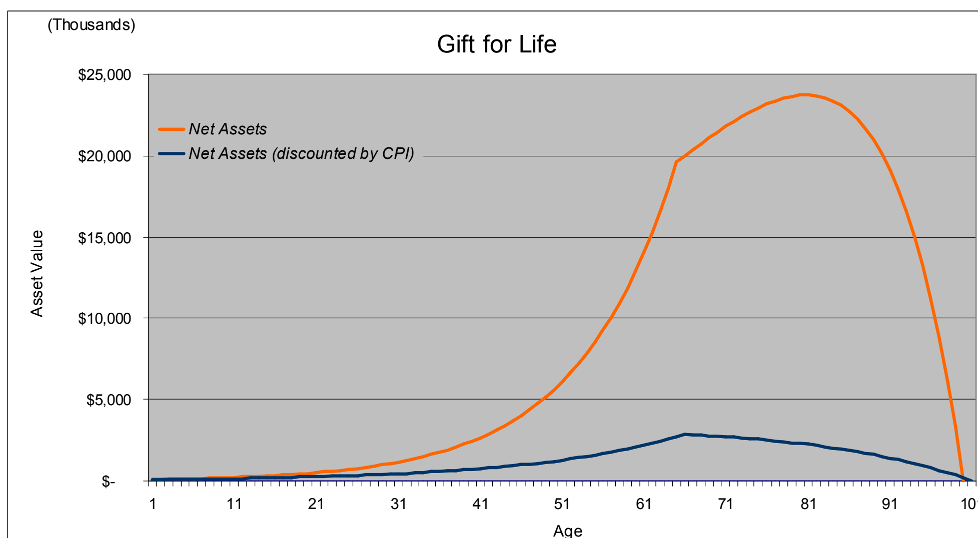
Gift for life – Invest for your Children

Here's an interesting thought. Suppose you and your partner have just "had" a baby. **What will it take to ensure financial security for your little one once he or she retires?** A good starting point is to send the little one off to school so that he or she gets an education. If all goes well, your kid will learn that by essentially providing for other people's needs one is remunerated in the form of a monthly salary. This ensures a monthly income and any spare cash can be put aside for retirement.

This is all well and fine, however one can go a step further by putting some cash aside when the child is born. The question is: **What sum of capital needs to be invested so that when ones offspring finally retires, he or she is totally financially independent?**

Taking a look at history – a fully invested portfolio ie 95:5 portfolio (Growth 95% and Defensive 5%) going back 30 years has delivered a 14.27% return or 8.86% above inflation before tax.

As this annualised return is unlikely to re-occur in the future we have forecast at 8.84% pa with inflation at 3% (thus a real return of 5.84% pa).Thus a small amount of capital today can become a much larger amount of capital in real terms in the future.



Let's assume that the person will retire at 65 and that the **monthly income requirement in today's terms is $15,000**. In addition, once the person retires, the capital providing the income delivers a real return of 5.84%. What pops out of the calculation is a figure of $84,000 which needs to be invested now to ensure that one's child can retire comfortably.

Thus with an initial investment of $84,000 it is possible to secure your child's retirement needs upfront. Alternatively, a monthly savings plan of $732 per month until your child is 18 years old would also suffice, or $400 per month escalating at 10% pa until your child is 18 years old would do the trick.

Would it not have been great to have been set-up for life with a certain retirement?

The figure of $84,000 assumes that an index return is achieved after costs (not entirely impossible if you choose a good manager and your financial advisor is charging a reasonable fee). In addition, we assume the individual ends up on a 46.5% marginal tax rate and that CGT applies at the rate of 23.25% (50% discount applies). In reality, the tax rate may well be lower especially if the funds are transferred partially into a Superannuation fund and other income splitting strategies are used.

Given these inputs, it is interesting to note that on retirement your child will have a retirement capital of $19.4m with a monthly income requirement of $102,000. After retirement, the capital amount should continue to grow until it reaches a high point of $23.7m at the age of 81, after which the capital would then begin to slide very rapidly towards zero at the age of 100. See attached graph of the capital profile over the duration of your child's life.

Give it a thought!

Back to school

It's that time of the year again for those clients who have children at Private Schools. We recently did some analysis work for a Private School whereby we compared the increase in school fees from 2006 to 2007. The increase was staggering. The year on year increase was approximately 15% (that is on the assumption that the child stayed in the same year!). However, the actual cash flow cost when the child moved up a standard was an annual increase of approximately 25%.

This type of analysis is important as Private School education can leave a massive deficiency in the Retirement nest egg for our clients. For those of you who may be budgeting at a far lower rate, we would suggest that you assess the previous years costs of your children's school as that should enable you to more accurately evaluate the future expected cost.

Estate Planning - Thoughts for your consideration

1. **Do you have a will for you and your spouse/partner?**
2. **Have you reviewed both yours and your spouse/partner's Superannuation and Insurances recently?**

   We constantly see clients who either have too much or too little insurance or the method of payment can be improved which will reduce the premiums in the long term by a significant amount. Wealth protection strategies should be reviewed at least every 2 years.

3. **Have you nominated your beneficiaries on your Superannuation and your personal insurances AND has your spouse/partner nominated their beneficiaries on their Superannuation and their personal insurances?**

   Are they up to date and relevant? You may have had a change in your personal circumstances recently, for example, got married and/or had children.

What can Horizon Wealth Management do for you?

Horizon Wealth Management is in the business of assisting individuals in the efficient management of their personal wealth, helping them to **become financially independent**.

"How successfully you invest your current income and assets…. will determine your family's long term financial well being"

Horizon Wealth Management provides objective and unbiased advice, a rare commodity today. Should you wish us to cover other topics or wish to make an appointment, please call 02 9392 8700 or info@horizonwealth.com.au.

General Advice Disclaimer

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