

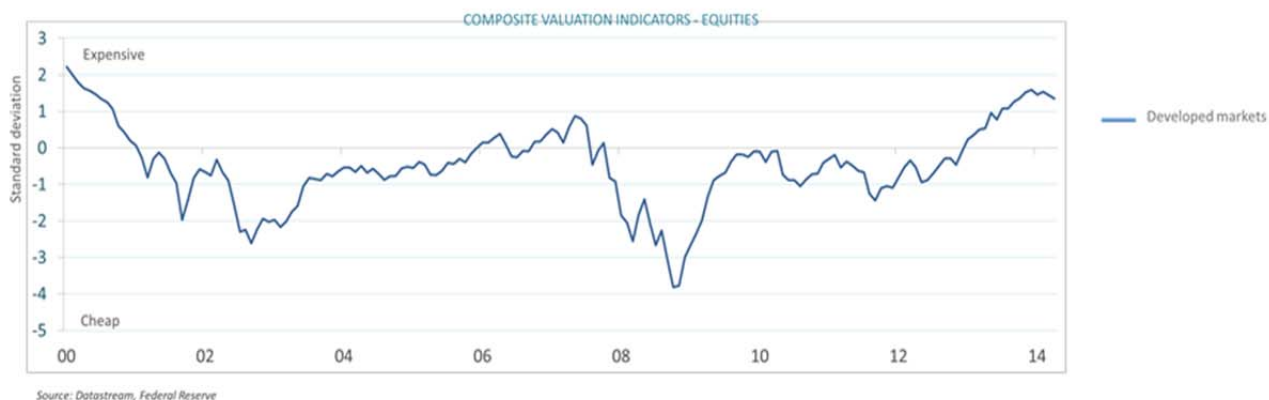
# Financial Directions

## The Multi-asset Odyssey: Outwitting seductive Sirens in a low-return investment environment.

You may be familiar with Homer's epic tale of ancient Greece - *The Odyssey* - where the protagonist Odysseus has a 10-year struggle to sail home to Ithaca across the Mediterranean Sea, following his victory in the Trojan War. During this time Odysseus faces the wrath of gods and is forced to do battle with a variety of powerful, mythic opponents. A notable scene is when Odysseus' men are travelling at sea and need to sail past the seductive Sirens, whose beautiful and irresistible singing has enticed many ships onto the rocks. Odysseus' solution is to have himself tied to mast (so that he can't do anything stupid); and to have his sailors plug their ears with wax (so that they are not distracted by the songs) – his ship successfully avoids being lured to its destruction.

Odysseus does not take the prize for the most pro-active anti-Siren strategy of ancient times. That distinction goes to another band of heroes, Jason and the Argonauts, who were also confronted with a need to overcome the blandishments of the Sirens. Jason and the Argonauts enlisted the assistance of Orpheus, the famous musician. Orpheus uses his lyre and plays his own music - even more marvelous than that of the Sirens – enabling the crew to make their passage successfully.

### Siren songs and the rocks of low return



### Resisting the siren songs in investment markets

Managing investment portfolios is akin to the challenges faced by these two groups of travellers. There's a high risk that "standard" investment opportunities in markets, with alluring multi-decade track records, may prove similar to the beautiful but dangerous creatures portrayed in the Greek mythology.

We believe that focussing solely on the seemingly safe havens of traditional equities, bonds and cash may lead to disappointing results. While these asset classes have delivered excellent outcomes for investors historically, we expect lower returns, and higher risk from them going forward and we are wary of relying on them uncritically.

1. **Developed market equities.** Russell's "Composite Valuation Indicator", pictured, assesses "value" in the light of a range of indicators including company profits; asset values; and interest rates. Although not yet at extreme highs, we believe developed equities are overvalued and over coming years are likely to deliver lower, single digit returns, and with greater volatility than in recent years.
2. **Traditional government bonds.** They were the best performing asset class through much of the financial crisis, and have been performing well over the past 12 months. Looking ahead, however, starting point yields on 10 year bonds, after allowing for inflation, are now unattractively low – a mere 0.5% in the 2010s so far, for the US. In Australia, the comparable rate is down to 1.5% in recent years. The next step for interest rates is most likely upwards, exposing portfolios to the dangers of potential capital losses.
3. **Cash.** Even the traditional safe haven of cash is unattractive going forward, as many central banks in developed countries are likely to keep their cash rates at or near 0% for the rest of this year at least.

“focussing solely on the seemingly safe havens of traditional equities, bonds and cash may lead to disappointing results”

### Finding better music for a smoother journey

The starting point then, for dealing with the prospect of lower returns and higher risks, is for Russell's multi-asset portfolio management team to "hold back", in the spirit of Odysseus and to take a lead from Jason and Orpheus – by proactively looking at new and better investment opportunities.

### Strategy 1: Emerging Markets

We see compelling value and less risk with Emerging Markets versus Developed Markets and are looking to increase our exposure to these markets. Emerging Markets have experienced decreases in market sensitivity in recent years and following the last few years of underperformance relative to Developed Markets, they are considered 'cheap' relative to fundamental value.

### Strategy 2: New sources of defensive exposure

While government bonds are not expected to provide the desired defensive characteristics for portfolios going forward. This is because interest rates are now so low, that the risks are high. Instead, we are looking at alternative investments such as volatility strategies. These are strategies which do well in volatile times, when share market performance is choppy or negative.

### Strategy 3: Active currency management

Over the last few years, the Australian dollar (AUD) has been a safe haven 'valet parking' investment for investors. However, going forward, the AUD is expected to continue to fall from its historic highs (the AUD reached \$1.10 in 2011) as the Australian resources boom ends and as our economy slows. We believe a USD currency exposure (through unhedged global asset exposures amongst other approaches) provides good diversification and defensive cushioning to a portfolio, as Australia continues to lose its global *mojo*.

### Strategy 4: Global unlisted assets

Compared to Australian core unlisted property, which is in the late stages of the valuation cycle and expensive, Russell believes

offshore opportunistic property provides a more attractive risk/return opportunity. Russell's global reach provides our portfolio managers with the ability to access this attractive opportunity.

### Russell's multi-asset odyssey

Russell has already implemented some of these enhancements in 2014 to date and is planning to implement the remainder into our multi-asset portfolios in coming months. We believe these new sources of returns will further help achieve our investors' required rate of return at a level of risk they can commit to - enabling investors to enjoy a smoother journey to their final destination.

*The multi-asset odyssey was first presented at Russell's 2014 Annual Investment Summit in Sydney by Graham Harman, Senior Investment Strategist, Asia-Pacific, and Andrew Sneddon, Managing Director of multi-asset solutions, Australia. For more information on Russell's investment process, please contact your Russell representative on 612 9229 5111 or visit [www.russell.com.au](http://www.russell.com.au)*

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# Ensuring the SMSF property Dream: How trustees can benefit from life insurance when investing in property

By Damien Mu, AIA Australia general manager – life insurance as seen in the Self Managed Super Magazine

As 2014 begins, the Australian dream of buying and owning a property is as strong as it has ever been before. Thanks to an improving housing market and relatively low interest rates, many people, particularly Generation Y, see property as a good investment opportunity to help build on their retirement savings.

Self-managed superannuation funds (SMSFs) have been identified as an attractive vehicle for Australians to finance their property dream, while also allowing more control of how their superannuation is invested. Through Limited Recourse Borrowing Arrangements (LRBAs), SMSFs can borrow money to purchase property. With house prices rising by nearly 10 per cent in 2013<sup>1</sup> across Australia's capital cities, many SMSFs now believe that the time is right to enter the property market. According to the Reserve Bank of Australia, \$18 billion of the \$500 billion in SMSFs is invested in residential property, about 3.6 per cent. Some speculate that this could rise to 30 per cent in the near future.

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<sup>1</sup>RP Data-Rismark monthly home value index, 2013

## The problem with using SMSFs for property investment

As with any investment option, there are risks that SMSF members need to consider. This is particularly the case when looking at property. Some of these disadvantages include:

1. The property must be at arm's length: While borrowing within an SMSF can help secure an investment property, the trustees cannot live in the property themselves.
2. Investing a large proportion of funds from an SMSF into one 'lumpy' asset does not adequately diversify the risk; and
3. Trying to liquidate the asset unexpectedly as a result of events like a fire sale from divorce, retirement, or even death, is often difficult.

The real issue arises when an SMSF uses a LRBA to acquire a property and is left with little or no assets remaining in the fund after the purchase. The expectation in many cases is that future earnings and contributions to the fund will service the debt; however, this approach can come unstuck with the unexpected death or permanent disablement of one of the fund members.

How will the trustee manage payment of a benefit to the beneficiaries or the disabled member or continue servicing the loan without insurance?

In these scenarios, the options are limited and include:

1. Selling the asset to repay the debt and to fund payment of the death benefit;
2. Commencing a pension to allow the fund the time to accumulate sufficient liquidity to allow a future commutation; and
3. An in-specie transfer of a part interest in the property to the beneficiaries or the disabled member.

Each of these options presents unique issues and may not always be viable, including:

1. **Sale of asset** - The timing of the sale may realise a capital loss for the SMSF, and will likely incur transaction costs. Alternatively, a capital gains tax liability may be created;
2. **Commencing a pension** - The beneficiaries, which can often include the spouse or adult children, may not be eligible to receive a pension or might be reluctant to do so. Furthermore, there will be tax consequences on future lump sum payments depending on the age of the deceased or the beneficiaries. Lastly, there might be a question mark about having sufficient liquidity to pay the pension and service the loan; and
3. **In-specie transfer** - The trust must have the right to acquire the legal ownership of the asset at the end of the LRBA. The transfer cannot occur if the property remains encumbered.

## How life insurance can safeguard SMSF property investment

Life insurance can play an important role in the investment strategy of an SMSF, and for trustees looking at investing in property, it should not be neglected. It can often be the difference in ensuring cash flow in an SMSF, paying off an LRBA or member benefit, should a fellow member pass away or be deemed permanently disabled.

At the completion of the Cooper Review into superannuation in 2010, one of the most notable findings was that less than 13 per cent of SMSFs had life insurance cover. This is partly due to a lack of awareness of life insurance offers within SMSFs. In a 2012 AIA Australia survey of advisers, brokers and accountants this was deemed the main barrier to SMSF members taking up life insurance within their fund. Two thirds (66 per cent) of respondents cited this as the main reason for an SMSF's shortfall in life cover.

The Cooper Review also recommended that SMSF trustees be required to consider providing insurance for its members and documented the consideration as part of the fund's investment strategy. And while there is no prescription of the type of insurance that must be considered by the trustee, it is advisable that this should at least address needs for death, total and permanent disability (TPD) and income protection cover.

There are a number of options available to SMSFs looking to purchase life insurance, whether through financial advisers, retail investment platforms and some SMSF administration platforms (e.g. ESuper). They are developed specifically with SMSFs and their trustees in mind. Some SMSF members choose to keep existing insurance with their industry super fund but the value of maintaining two separate accounts and paying additional administration fees is questionable.

From an investor perspective, holding insurance within an SMSF is important because they are unlikely to take out life insurance otherwise and risk being inadequately covered – only 21 per cent of SMSF clients had life insurance outside of their super.

For more information about AIA Australia's Life Insurance, please contact your financial adviser or visit [www.aia.com.au](http://www.aia.com.au)



## To illustrate the difference of having life insurance versus not having it, let's take a look at a few case study examples.

### SMSF Case Study 1: No insurance

David and Andrew are business partners who purchased their business premises through their SMSF. The fund borrowed \$600,000 from their bank to pay for the purchase of the property valued at \$1 million, using their accumulated super balances of \$400,000 for the difference. David and Andrew each have a 50 per cent interest in the benefits payable from the SMSF.

When David passes away a few years later, the property is now worth \$1.2million and still owes \$600,000. Because of recent contributions, the fund had accumulated about \$100,000 in cash. The net balance of the SMSF is \$700,000.

David nominated his wife, Dianne, as the sole beneficiary and she is entitled to receive \$350,000 from the fund representing David's 50 per cent interest in the fund.

However Andrew and the trustee have a few issues to confront:

- The fund only has \$100,000 in liquid assets to pay the \$350,000 death benefit to Dianne;
- The fund is unable to in-specie transfer part of the property to Dianne because there is still debt on the property;
- Andrew does not want to sell the property as he will lose control to the new owners; and
- Dianne doesn't want to receive a pension as she wants a clean break from the business

Andrew is forced to sell the property and is unable to realise the current valuation. This means that Dianne receives a reduced payout and Andrew has lost control of his business' premises.

### Case Study 2 – insurance in the SMSF

Let's assume the SMSF trustee takes out life insurance policies of \$600,000 on each of David and Andrew's lives. When David passes away, the insurer pays a life cover benefit of \$600,000 to their SMSF. This increases David's benefit from \$350,000 to \$950,000.

The SMSF trustee could use the life cover benefit to pay off the \$600,000 debt on the property. The fund will still be left with \$100,000 in liquid assets which is insufficient to pay the death benefit of \$350,000 to Dianne. Andrew can either:

- In-specie transfer about 80 per cent of the property to Dianne, although Dianne would end up owning a majority interest in the property which would be unacceptable to Andrew, and she has already indicated that she doesn't want to receive a pension; or
- Sell the property; or
- Use the \$600,000 from the insurance benefit and the \$100,000 in cash to pay a cash lump sum to Dianne. Any shortfall would need to be funded from the sale of the property as an in-specie transfer in these circumstances is not possible while the property is still encumbered.

### Case Study 3 – insurance in the SMSF where policies are cross owned

In this scenario, David and Andrew took out life insurance policies on each other's lives for \$850,000. Their lawyers drafted an agreement between them and the SMSF trustee that required a surviving partner to use the proceeds to buy the other person's interest in the property from the fund.

When David passed away, Andrew received \$850,000 from the insurance policy and used it to purchase a share of the property in his own name. This allowed the fund to use \$600,000 to pay off the debt. The remaining insurance benefit of \$250,000 and the accumulated cash savings of \$100,000 can be used to fund payment of the \$350,000 death benefit to Dianne.

This strategy was able to achieve the following three goals that the partners had agreed were important:

- Paying off the debt on the property;
- Being able to retain ownership and control of the property; and
- Making sure that the SMSF could pay out a cash lump sum to the deceased partners' beneficiaries.

### Conclusion

The current strength of the property market in Australia is increasing the attractiveness of using SMSFs as a vehicle to purchase investment properties. And while SMSFs do allow trustees to pursue this investment strategy, there are significant risks that go along with this if no life insurance is held within the fund.

As we've seen, implementing an LRBA can throw up many challenges if one of the fund members were to die or become permanently disabled. It's therefore important to consider what will happen to the debt, the relationship between the members and the liquidity in the fund.

Life insurance can be used to mitigate some of the risks and protect members of the fund but it's important that the members understand these risks and what will happen if one of them was to die or become permanently disabled.



# Comparison rates explained

When you're buying a home, there are new decisions, considerations and jargon to decipher. Even interest rates can be confusing – with a 'comparison rate' being shown beside the advertised rate.

## What is a comparison rate?

When home loan interest rates are displayed, a comparison rate is also shown alongside it. A comparison rate helps you compare the costs of different home loans. They take into account not only the interest you will be charged, but also known fees and charges relating to the home loan. This can help you understand the true cost of a home loan. For example, one home loan may have an interest rate of 5% p.a. and a comparison rate of 5.5% p.a. when fees and charges are included. Another loan may have a lower interest rate of 4.5% p.a., but a comparison rate of 6% p.a., because it has higher fees and charges either initially or over the life of the loan. The second loan may look more attractive because of its lower interest rate, but the comparison rate helps you understand the true cost when certain fees and charges are taken into account. And all comparison rates are calculated on a designated amount for a set term, so it helps you to compare apples with apples.

## Costs to consider in addition to the comparison rate

Comparison rates take into consideration 'known' account fees and charges, however, there are other items you will want to take into account and understand, such as stamp duty and conveyancing fees associated with the initial purchase of a property, and fees for optional features. There may also be government charges, which can vary depending on your location and the property you are buying. It's also important to look holistically at all the features that a home loan offers, and consider the savings that could be made through features such as an offset account, or access to additional repayments through redraw. Other features like making extra payments and splitting your loan between fixed and variable interest rates are not included in the calculation of the comparison rate but should form part of your decision making when working out which home loan will suit you.

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