Aspirations

Live the life you desire now and in the future

October 2013

genesys WEALTH ADVISERS

The Insider

Welcome to the first edition of Principal Wealth's newsletter - The Insider.

With the first half of 2013 behind us, we can reflect on what has been a very busy period for our company. Principal Wealth continues to grow with our focus firmly on providing our clients with professional service & advice based on their needs, not what they have.

We successfully ran the 1st seminar of our Education Seminar Series in August on Self-Managed Super & Insurance. The 2nd seminar of the series will be held on October 17 on Estate Planning. If this topic is of interest to you, please contact Principal Wealth for more details.

Should you have any questions on anything covered in this newsletter we encourage you to call Principal Wealth and speak to one of our Financial Advisers. Happy Reading!

Investing: an emotional business

Common sense may say that the time to invest is when markets are down, but the reality is that most investors wait until markets are running hot before they get on board.

The psychology of an investor plays a significant role in what drives financial markets and explains in part why the prices of many assets, including property and shares, go through booms and busts.

Two common characteristics of human behaviour that tend to play havoc with many investors' decision making and investment markets are fear and greed.

Fear may prevent you from buying something when it appears to be out of favour because of the possibility of losing money. Greed may encourage you to aggressively chase returns into investment opportunities beyond your normal comfort level.

Rational investors may be less worried about the risk of losing money in the short term. They are more focused on the possibility of long-term gains based on their view of the company and broader economic conditions. This person may invest **regardless** of what the market is doing.

The same investor might prudently rebalance their portfolio back to a desired asset allocation using an objective rationale.

Rather than make decisions rationally based on available information, most investors left to their own accord are much more likely to let their emotions drive at least part of the process.

It is because of emotion that most investors sell when markets are close to their bottom and buy when markets are nearing their peak.

Loyalty doesn't always pay

Feeling loyal towards an underperforming company just because you have held the shares for a long time is no reason to keep them. Nor is buying shares in a company just because you are envious of others having them.

There are numerous investor behaviours that may be hard to identify and control. It may be dwelling on what has happened in the past as an indication of what may happen in the future or getting carried away and making over-zealous decisions when markets are running hot.

Reactions such as these can be common, particularly when markets are going through periods of boom and bust. It is important to understand that investment markets are driven by more than just fundamentals and that investor psychology plays a significant role.

Just by understanding emotion and logic, this can play a vital role in the decision making process and can go a long way in helping you make rational decisions.

Common biases

There are several common biases that have been identified by psychologists as influencing investor behaviour; once recognised these biases may be resolved:

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Investing: an emotional business continued

Herding[1]:

Safety may well come in numbers, except when the numbers are only growing because others are there. The reality is that large numbers of people can be wrong and when they are, the damage can be a lot worse. By following the crowd, or herding, individuals are more likely to buy when markets are near their top and sell at the bottom.

Familiarity[2]:

Investing in a company or an area you are familiar with is understandable, but there may be consequences if part of your aim is to have a diversified portfolio. For example, buying shares in companies in only your own country, while ignoring opportunities in other countries, fails to recognise the benefits of diversifying against geographical risk.

Anchoring[3]:

Nobody likes to think they have made a bad investment decision, but it doesn't always pay to get set on something like a share price or old information. A company whose shares suddenly drop from $20 to $10 isn't necessarily going to get back to $20 just because it was there once.

Loss Aversion[4]:

If there is a good way to destroy investment returns, it is to hang onto loss-making investments in the belief they will come good and to sell winners quickly just for the instant gain. We do this because we feel more pain from a loss than we feel happiness from a gain.

The highly successful US investor Warren Buffett turned the phrase "be fearful when others are greedy and greedy when others are fearful"[5] knowing that investors don't always act rationally and when money is involved, emotions can run high.

Speak with your financial adviser on how you can maximise your investments.

1 'Psychology and investing', George Watkins, 2012, viewed 26 March v2013, http://invest-it-yourself.com/blog/psychology-and-investing-%E2%80%93-common-behavioral-biases/

2 'Three behavioural biases that can affect your investment performance', CFA Institute, 2011, viewed 26 March 2013, http://www.forbes.com/sites/cfainstitute/2011/12/21/three-behavioral-biases-that-can-affect-your-investment-performance/

3 'Three behavioural biases that can affect your investment performance', CFA Institute, 2011, viewed 26 March 2013, http://www.forbes.com/sites/cfainstitute/2011/12/21/three-behavioral-biases-that-can-affect-your-investment-performance/

4 'Three behavioural biases that can affect your investment performance', CFA Institute, 2011, viewed 26 March 2013, http://www.forbes.com/sites/cfainstitute/2011/12/21/three-behavioral-biases-that-can-affect-your-investment-performance/

5 Wikiquote, 2013, viewed 26 March 2013, http://en.wikiquote.org/wiki/Warren_Buffett

Small business and social media

It's taken less than a decade for the word 'like' to go from a passive compliment you might apply to a slice of cake to the cornerstone of the biggest social media revolution since the phone book.

Facebook and its social media relatives like Twitter, LinkedIn and YouTube are used by millions of Australians every day. However, these, and myriad of other forms of digital media tools, create unique challenges for small businesses attempting to build a marketing program with often limited resources.

A good place to start is the Australian Communications and Media Authority's digital media literacy research program, which provides essential information relating to digital media literacy levels in Australia.

CPA Australia social media manager Jillian Bowen then suggests businesses pose a series of simple questions before creating an effective digital media plan.[1]

- What do I want to achieve?
- Why will this be more beneficial than other tactics?
- Who is my target audience?
- Where does my audience spend the most time?
- When will I fit this activity into my existing work schedule?
- What is my competition doing in the online space?

"The bigger the business, often the bigger the established audience. For a small or new business, the process of identifying and connecting with an audience is significant so it's an extra hurdle above and beyond the education, set-up process and ongoing management of their social media presence," Bowen said.

Director, Andrew Kent of B2B marketing consulting agency Green Hat, said digital media offered many advantages for the small business owner.

"Social media also has a lot to do with personality and personal representation. For a smaller business, the senior managers or founders are often an important part of the brand, so social media is a more natural fit for them," Kent said.

"But with B2C, you need to consider what sort of business you are and how people find you."

Certainly for services industries social media is most helpful for creating communities, giving companies another way to converse with customers and provide a better customer experience.

Erica Swallow from leading digital innovation website Mashable also advises that

opportunities for small businesses go well beyond a Facebook status update.

"New tools are allowing small companies to efficiently mine data like the big boys; eCommerce on tablets is growing at a staggering rate while niche media properties like blogs and eBooks allow businesses to connect with their target audiences like never before," Swallow said.

Digital media may not have completely replaced the community noticeboard or Yellow Pages listing, but the opportunities have added some valuable weaponry to the marketing arsenal of the small business.

1 Carly Greenwood, 'Social media strategies for small business', 23 August 2012, ITB Digital, viewed 13 December 2012, http://www.itbdigital.com/opinion/2012/08/23/social-media-strategies-for-small-business/

All in the family

The traditional idea of a family made up of the kids with their mum and dad has shifted for many Australians, with nearly one in three children now living in a step, blended or single-parent family.[1]

We know that issues about estate planning can be complicated enough is what the Australian Bureau of Statistics calls an "intact" family, but when family dynamics change, keeping everyone informed and happy can become increasingly complex.

A modern will

Traditionally, people dealt with the distribution of their estate through the creation of a will. Usually prepared by a legal professional, a will sets out directions for the administration and disposal of property after death.

However, modern families require modern estate plans which are best prepared in discussion with your financial adviser and a specialist estate planning lawyer. As well as catering for different situations there are different assets to consider, which may not meet the definition of "property" when it comes to wills.

While the correct distribution of assets may be important, so is the protection of those assets for future generations. An inheritance received in the name of an individual can just as easily be lost as result of a divorce settlement or in the case of a business collapse.

Money and assets can just as quickly disappear where the beneficiaries are children or vulnerable people such as those with disabilities, addictions or poor money management skills.

Trusts and other assets

Testamentary and discretionary trusts can be set up as part of a will as one way to protect and distribute assets in a tax effective manner.

When a person dies the trust comes into effect and a nominated trustee then distributes the money to the named beneficiaries according to your wishes as testator.

Because the trust is a separate legal entity, assets inside the trust are generally protected from future events such as divorce proceedings or creditors.

Superannuation and insurance policies are also separate legal structures that can hold considerable sums of money, and both need to be considered in a broader estate plan.

But they may fall outside the property covered by a will, so beneficiaries may be nominated independently of the will to receive the death benefits from the superannuation fund or the proceeds of a life insurance policy upon death.

Where children or vulnerable beneficiaries are the proposed beneficiaries of a life policy you might talk with your adviser about directing the proceeds to a trust.

While family conversations about estates and death can be confronting, it is important to inform those close to you of your plans. You may want to include your financial adviser in this discussion, to make sure all the important details are included.

Case Study

John and his wife Marie have one young child, Sarah, while John also has two adult children from his previous marriage.

John's will states that Marie inherits his estate. John wants to make sure his two older children also receive something but is concerned about his older daughter's ability to manage money and his son's rocky marriage.

John sits down with his financial adviser and identifies all the assets in his estate such as his home and investments, plus $600,000 in his superannuation fund and a $1 million life insurance policy.

John's super fund allows him to make binding death benefit nominations and he requests that his death benefit be paid to his legal personal representative when he dies.

With the help of a solicitor, John's will now provides for the establishment of two testamentary trusts. Sarah is a beneficiary of one, and his two older children are the beneficiaries of the other.

He appoints his brother to act as the sole trustee of the trust for his older children, and Marie for the other trust. He nominates that on his death the proceeds of his life insurance policy be paid to the trust for Sarah. John discusses his arrangements with his wife, his brother and each of his adult children to give them as much information as possible.

When John passes away, Marie will inherit the house and other assets. His $600,000 superannuation benefit will be paid to his estate and will be included in the assets over which the trust is established. His insurance policy will be paid in the same way. His brother has the final say in the distribution of income and capital from the trust to John's older children which ensures it is not spent at once or automatically included in any future divorce proceedings.

As the trustee of the trust for Sarah, Marie controls the funds Sarah receives.

By having a well-considered estate plan, John's assets are distributed to his nominated beneficiaries at the most appropriate time and in the most tax effective manner.

1 Families then and Now, 1980–2010, by Alan Hayes, Ruth Weston, Lixia Qu and Matthew Gray, Australian Institute for Family Studies, http://www.aifs.gov.au/institute/pubs/factssheets/fs2010conf/fs2010conf.html#household. See also Australian Bureau of Statistics. (2008a). Family characteristics and transitions, Australia, 2006-07 (Cat. No. 4442.0). Canberra: ABS.

Searching for yield

Forget the search for El Dorado; investors these days are looking for something more tangible. They want the certainty of cash in the hand at better rates than those on offer at the bank, but after the turmoil of recent years they also value security.

With the cash rate at a record low around 3 per cent and term deposit rates below 4 per cent, investors must look elsewhere for a decent yield from the fixed-interest portion of their portfolio, and that is where bonds fit in.

Put simply, a bond is a loan provided by you, the investor, to the issuer who may be a government, a company or other body. The bond issuer promises to make interest payments, called the coupon, and repay the principal at specified dates.

People buy bonds for income and the security of knowing they will get their money back in full if they hold onto their investment until maturity. Of course the higher the quality of the bond (eg. AAA rating), the lower the yield and the lower the chance of default. Unlike a term deposit, bonds can be bought and sold on the secondary market. This provides bondholders with the opportunity to make capital gains to boost the total return from their investment.

There is an inverse relationship between the value of a bond and interest rates. If interest rates fall, the value of your bond will increase because it pays a fixed rate of interest based on its face value. If interest rates rise, the market value of your bond will fall but you still recoup your initial investment if you hold to maturity.

There are many kinds of bonds but government bonds are the standard against which most fixed-interest investments measure themselves in terms of both risk and return.

Government bonds

Commonwealth bonds are issued and guaranteed by the federal government while semi-government bonds are issued by state governments, to finance infrastructure and other spending programs. You can also buy bonds issued by local government authorities and government-guaranteed authorities like Telstra.

Most government bonds pay a fixed coupon rate but you can also buy inflation-linked bonds where returns are adjusted for inflation over the life of the bond.

Top ranking government bonds are AAA-rated and the coupon reflects that. Although it must be stressed we are talking here about bonds issued by the likes of Australia or the US, not Greece or Spain. The higher the credit rating, the safer the investment and the lower the interest rate needed to attract investors.

In recent times Australian Government 10-year bonds have paid interest of about 3.5 per cent. That is not much of an incentive to invest for 10 years, but foreign investors have been lapping them up because Australia is regarded as a safe haven, albeit with a high Australian dollar. Not only that, but 10-year US Treasury bonds pay interest of just 2 per cent and shorter-term US bonds pay close to zero.

If you want to earn a better return on your fixed-interest investments, you need to turn to the corporate sector.

Corporate bonds

Corporate bonds are issued by companies at fixed or floating rates of interest where the coupon rate varies in line with some market indicator. They are higher risk than top-rated government bonds so quality is the key.

This is because the promise to pay regular income and repay your capital depends on the creditworthiness of the company and the quality of its assets.

In other words, there are no capital or income guarantees with corporate bonds. Even so, they are less risky than shares. If a company fails, bondholders will get their money back before shareholders.

As experienced investors know, there are rewards for accepting some level of risk. The challenge is to make sure that you understand the risks and that you are being adequately rewarded.

For example, when BHP Billiton launched a $1 billion bond issue last year it was snapped up by investors, despite offering a coupon of just 3.75 per cent[1]. The reason for this was the perceived safety of the investment by the market. But you can also find bonds issued by smaller listed companies, which are well known and well run, offering coupons of up to 7 per cent.

A balancing act

Used wisely, bonds are designed as an income diversifier, providing some protection for your investment portfolio from market downturns. While they may be boring, they can also be complex so you may need professional advice to select the right investment mix.

Bonds do their job best when you hold different types of securities with different risk and return profiles to minimise any losses. It also means selecting bonds with different maturities to protect against adverse interest rate movements.

Most people will find it easier to achieve the necessary diversification with a bond fund where professional managers buy and sell bonds for capital gains as well as income. Then you can sit back and enjoy a regular income without sacrificing safety.

1 Jonathan Shapiro, 'Big Australian boosts local bond market', The Sydney Morning Herald, 10 Oct 2012

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