money matters

client newsletter volume five edition four

Investment lessons of a lifetime

Widely regarded as one of the most successful investors in the world, Warren Buffett is as famous for his wit as he is for the investment skills that have put him among the world's most wealthy people. But what can you learn from the insights that have made him so successful?

On investing when the market is falling:

Buffett says, "Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."[1] One of his most famous quotes of all: "Be fearful when others are greedy, and be greedy when others are fearful.[2]

On value investing:

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price" or, more succinctly, "Price is what you pay. Value is what you get.[3]

Buffett's advice is to invest in the future of the business: "If a business does well, the stock eventually follows." He studies annual reports in detail, but warns that "Managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation"[4] and, with typical Buffett cynicism: "I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will.[5]

On timing the market:

Buffett is a long-term investor. As he says of shares, "Our favourite holding period is forever."[6] He freely admits that he has "… no idea of market timing. It's easier to tell what will happen than when it will happen,"[7] and adds that "The fact that people will be full of greed, fear or folly is predictable. (But) the sequence is not predictable."[8] He also agrees it is deceptive to judge future performance by events of the past, pointing out that "The investor of today does not profit from yesterday's growth."

These are not just pithy quotations. Buffett has revisited and expanded these themes many times. He attributes his wealth to sticking with the investment basics – value investing in the shares of quality companies while making a long-term commitment, and staying with the market through good and bad times rather than trying to pick the market's rising periods.

When it is boiled down, Buffett's most valuable secret is no secret at all. Sticking with it is the secret!

1 http://warrenbuffettnews.com/top-20-quotes-from-warren-buffett/ 2 http://www.theinvestorsjournal.com/be-greedy-when-others-are-fearful3 http://www.stockwatch.com.au/articles/fundamental-analysis/warren-buffett.aspx4 The Essays of Warren Buffett : Lessons for Corporate America (2001), p. 183 5 http://www.marketfolly.com/2009/09/top-25-warren-buffett-quotes.html#ixzz1p4BDCmKt6 http://stockmarketinvesting.com.au/Buying-for-Dividends.html 7 ibid8 http://www.marketfolly.com/2009/09/top-25-warren-buffett-quotes.html#ixzz1p4BDCmKt

Helping hand for self managed superannuation

Help is at hand if you want the benefits and independence of running your own self-managed superannuation fund (SMSF), but not the burden of administration.

Even the most independent SMSF trustee can't do it all by themselves. A recent survey[1] showed that 71 per cent of SMSFs sought professional advice about their fund, demonstrating that most SMSF trustees recognise the value of external support.[2]

You can outsource virtually everything from fund administration to choice of investments, without losing control and flexibility, which are probably key motivations for setting up an SMSF. The only thing you can't outsource is your responsibility as a trustee to ensure the fund is properly managed and complies with all the rules.

Outsourcing administration

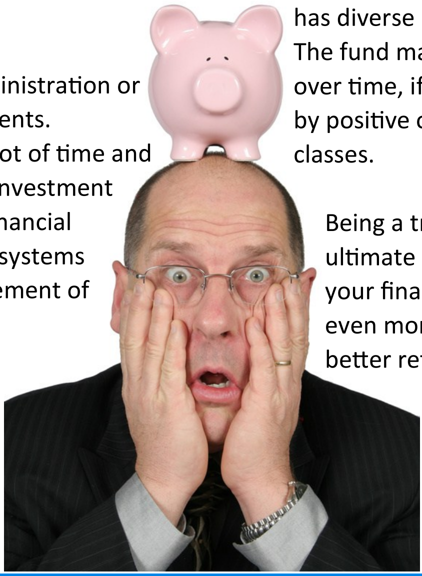
You may elect to outsource all the administration or just the end-of-financial-year requirements. Administration can, after all, involve a lot of time and effort; and working out such things as investment cost bases is not for everybody. Your financial adviser can provide you with access to systems and platforms that simplify the management of your SMSF.

A key to a successful SMSF is to make sure the fund is compliant at all times. Issues include ensuring both concessional and non-concessional contributions are within their respective caps, continuing to meet the sole purpose test, and ensuring the minimum pension payments are made. This is when it can prove invaluable to seek assistance, as a professional administration service keeps track of all these issues.

Outsourcing investment choices

Aside from the administrative part of an SMSF, many trustees may not have confidence to choose or adjust the investment mix to give the fund's portfolio the necessary diversification to ride the asset class cycles.

Given your financial adviser's familiarity with other aspects of your finances, tax strategies and ownership arrangements, they can take a holistic approach to your SMSF. But even if you can work out your asset allocation, do you really have the time to research every stock in which you want to invest? Your adviser has diverse research resources at their fingertips. The fund may also need to rebalance the portfolio over time, if the original asset allocation is skewed by positive or negative performance within asset classes.



Being a trustee of an SMSF means you have ultimate responsibility, but by working with your financial adviser, you may enjoy the role even more — and potentially benefit from better returns.

1 Australian Financial Review, Smart Money, reported March & May, 2012.

2 Financial Review Smart Investor reader survey' in the May 2011 edition (PDF)

Life expectancy improves for Australians

Over the past decade Australia has seen significant increases in life expectancy. Males are expected to live an extra three years on average, as estimated by the Australian Bureau of Statistics.

These increases have been partly due to lower infant mortality, fewer young people dying in motor vehicle accidents, and fewer older men dying from heart disease. In Victoria, a baby boy born today can expect to live up to 80, up from 77 just a decade ago and a baby girl can expect to live up to 84.3 up from 82.3.

Other reasons for increasing life expectancy have been attributed to improving social conditions and advances in medicine such as immunisation and antibiotics.

Demographer Peter McDonald of the Australian National University, attributes the closing of the gap to healthier lifestyles, less smoking, less drinking and far fewer motor vehicle accidents. But increased life expectancy and population growth has considerable implications for government spending on health, age related pensions and aged care, and the workforce's ability to maintain current levels of economic growth.

The number of years spent in the workforce as well years out of the workforce, means planning your future is even more critical to ensure that you have enough support in retirement.

Safeguard your business for the unexpected

Mary, Wayne and John are co-owners of a successful business. John contracted a serious disease and died after a number of years. He left his share of the business to his wife, Betty.

Many years prior to John being diagnosed with the illness, the business had taken out $200,000 of life cover on each partner for use as Business Ownership protection. However, no Buy/Sell agreement was put in place. After John's diagnosis, he was unable to obtain more life insurance.

Over the years, the business grew significantly where John's share was valued at $780,000. The partners had not reviewed the insurance policies to maintain the cover levels in line with the value of the business. This left Mary and Wayne with a $580,000 shortfall.

This presented a dilemma for Mary and Wayne. They couldn't afford to buy out John's share of the business, nor could they afford to obtain a loan for that purpose. This left them with a number of unpalatable options, including:

- Accepting John's wife as a co-owner. The problem here is that Mary and Wayne do not get along with Betty…and Betty has no skills to help in the business. So Mary and Wayne would be doing all the work and giving a third of the profits to Betty.
- Or Mary and Wayne could find a third party to buy the business and use that money to pay out John's wife – but there aren't any obvious takers that Mary and Wayne know already. So they would have to take on a new partner who they don't know – possibly leaving them vulnerable to someone they won't get on with – either personally or professionally.
- Another option is to sell the business and pay out John's wife from the proceeds. The problem here is that, without John, the value of the business is a lot less. It is not the best time to be selling. In any case, Mary and Wayne both love the business and don't want to sell.
- The final option is to get Betty to agree to receive the initial $200,000 and then receive regular payments under a vendor terms arrangement. The problem here is that Mary and Wayne are effectively in business with Betty until she is finally paid out. This also means that the business needs to generate Betty's payment and pay it in addition to the existing costs of running the business.

What happened?

Mary and Wayne had numerous meetings with Betty and rather than the business folding, Betty's lawyers agreed to the following:

- Receive the $200,000 insurance payout as an initial payment.
- Receive $9,000 per month, indexed each year for inflation for the next five years.
- At the end of the five years, subject to a valuation of the business, the payments would continue or Mary and Wayne could pay a final lump sum.

A better solution

It's too late now, but Mary, Wayne and John should have put a buy/sell agreement in place from day one. They could have funded it with an insurance policy that covers death, and serious illness or disablement. Plus they could have obtained a valuation of the business from their accountant annually and adjusted the insurance sums insured accordingly.

As a result, on John's death, Mary and Wayne could have paid John's wife the agreed amount and Mary and Wayne would then have owned the business outright.

The insurance cover required for Death, TPD and Trauma of $780,000 for each partner would have cost each year: Mary $4,691, Wayne $3,692, John $2,996 (based on the following parameters:
- Mary age 44, Wayne age 42, John age 40
- Business valuation: $2,340,000).

That's a total of $11,379 or just 0.49% of turnover.

Definitions: Business estate planning

Business estate planning is the process of arranging your business affairs now to help ensure there is no unnecessary deterioration or loss of continuity in your business should it lose you or one of the other owners or other key people through illness, injury or death.

With appropriate business estate planning, there should be less risk of:

- A departing owner, or their spouse or estate, taking legal action over a valuation or pay-out figure
- A departing owner's spouse or child deciding – against the wishes of the continuing owners – to become an active hands-on partner of the business (rather than taking the pay-out)
- The departing owner's spouse or family taking their legal right to claim a share of the business profits without having to work in the business
- A departing owner's spouse or estate selling their share of the business to a third party that may be unsatisfactory or unknown to the continuing owners
- The control of the business or its assets being frozen due to legal difficulties created by the departing owner, or their spouse or estate.

Make first home saver accounts work for you

If you are saving for your first home, a first home saver account is a good way to help you reach your goal. The government will contribute an extra amount that is a percentage of your savings each year.

These accounts have a few rules so it's important to make sure they are right for you.

Unlike other savings accounts, a first home saver account can only be used when you are saving to buy or build your first home.

Each year the government will make a 17% contribution on the first $6,000 you deposit each year. This means that if you deposit $6,000 in one financial year, you will receive $1,020 from the government.

Some of the main features of these accounts are:

- The interest you earn on the account is only taxed at a rate of 15%.
- You have to save at least $1,000 each year over at least 4 financial years before you can withdraw the money. These 4 years do not need to be consecutive.
- The maximum account balance is capped at $90,000 but this cap will be indexed in future years. After your savings reach this level, only interest and earnings can be added to the balance.
- The money has to be used for your first home. If it is not, it is added to your super and you can't access it until you are retired or can meet another condition of release.
- If you buy your first home before the 4 year period is up, you can withdraw the money in your account at the end of the 4 year period to put towards your mortgage. You will not be able to make any more deposits once you have built or bought a property.

Is it right for you?

Make sure you think hard about your future needs before opening a first home saver account. If, for example, you decide in 3 years that you'd rather move overseas or put the money into a new business, you won't be able to immediately withdraw the money from your account. The money will be transferred to your super and you won't be able to access it until you are retired or can meet another condition of release. Consider all your savings options. You may prefer opening a different kind of savings account that is more flexible than a first home saver account.

Saving with your partner

First home saver accounts can only be opened by an individual, so if you are saving with a partner you should each open an account. You will only have to wait until one of you reaches the 4-year savings mark to withdraw from both accounts, provided your house is bought in both your names. If you both have accounts, you will also both be eligible for the government contributions.

You may use your first home saver account to buy a property with a partner who has previously owned a home as long as you are a registered owner and this is your first home.

Case study: Alex and Tony

Alex and Tony each have their own first home saver account. Alex has been saving at least $1,000 each year for 5 years while Tony has only had his for 2 years. But because Alex's account has been open for 5 years, they satisfy the 4-year rule. They can combine their savings to buy their home.

For more information about these types of facilities, please speak to the financial planning office below.

12 Bowman Street SOUTH PERTH WA 6151

PO Box 1457, SOUTH PERTH, WA, 6951

Phone (08) 9474 5008   Facsimile (08) 9474 5009

Email markr@paradigmsp.com.au

PARADIGM STRATEGICPLANNING