FINANCE CONTROL

GOALS - OBJECTIVES - ADVICE - LIFESTYLE

Spring 2011

Welcome

A warm welcome to our Springtime newsletter. This is traditionally a time of renewed activity as we emerge from colder times. In the financial world it has certainly been a time of great activity but not a lot of it has been enjoyable.

In this issue, we look at sovereign debt levels in Europe and the US, and why concerns about debt seem to have set off the upheaval the markets experienced in August. In particular, we look at why the turmoil overseas may be relevant to Australians.

We also put the focus on one of the vital areas of insurance, income protection. There are many options available which help to provide households with financial breathing space when it is most needed. Our final article takes a look at the growing trend towards saving our pennies. It seems we are doing what our grandparents would have advised us to do by saving for those rainy days.

Latest news

We may have come through winter into spring but the economic mood is tending towards a ‘glass half empty’ view, weighed down by share market volatility and unresolved questions about debt levels and slow growth in Europe and the US. Despite a fall in consumer confidence in August, the Australian economy is still positioned to build on the demand for raw materials from our Asian trading partners.

At the same time, even though the recent company reporting season has been more good news than bad, the term ‘patchwork economy’ will be heard more frequently in coming months. Tourism, higher education and the manufacturing sector are all feeling the pinch from our strong dollar. These pressures, and rising household savings levels, have constrained consumer spending and that looks likely to continue.

While unemployment levels remain around 5 per cent nationally, in recent weeks there have been well-publicised layoffs from major manufacturers. Housing prices remain subdued but stable, while building approvals are up slightly.

Despite our Asian links, US economic activity remains important. In a welcome sign, US consumer spending rebounded in July to record its best figures for five months. The months ahead might be like early spring — some green shoots in among some brown patches.

THE DEBT CRISIS NOT OUR PROBLEM?

Australian investors watching the recent market turmoil may feel like innocent bystanders caught in the crossfire of the sovereign debt battles in the USA and Europe. Our own debt has a AAA rating, so how can it be our problem?

The answer lies in one magic word — global. Government or sovereign debt tends to involve the world's big players. Most countries issue government bonds which are bought by other countries, foreign banks, and investment funds.

The debt web

China holds over $1.1 trillion, or a third of its foreign exchange holdings in US Treasuries or bonds, partly to manage its exchange rate and keep its exports competitive. In Europe, the French are owed over $500 billion by Italy, while Spain owes both Germany and France over $200 billion. And so it goes on.

It's a giant global web, which gives the system strength while it remains in balance. But when a major link weakens, it all threatens to come apart. It is this fear which is currently hurting world markets.

The worst case scenario is that a country may default on its loans. Or it may be de-rated, as Greece was, meaning it has to pay higher interest on its borrowings.

Debt can be reduced by raising taxes, cutting government spending, or both. Each requires strong political will. Improved economic growth has a major role to play but that is hard to achieve when austerity and fear dominate.

Paying the interest

The rate of interest paid by countries on their government-issued bonds is influenced by the rating agencies which rate each country, and also by the market response to new bond issues. The highest and best rating, AAA, means the borrower country pays a lower rate than a AA+ rated country, as it is considered to be lower risk.

As the debt builds up in any country, so does the interest bill, which then reduces the money available for schools, hospitals and infrastructure. In the USA, the debt burden more than doubled from $6 trillion in 2004 to $14 trillion in 2011. This led to a political arm wrestle in early August as the US Congress battled over a further increase to the debt ceiling, and how to pay it back via spending cuts or tax increases.

With Europe already struggling to find a solution to the problems of Greece, Spain and Italy, the decision by Standard & Poor's to drop their rating on the US from AAA to AA+ became the specific trigger for the current crisis in world markets. The re-rating of the US placed more pressure on the Euro countries, which had just brokered a fragile solution to the debt problems of their weakest members.

But why us?

But where does Australia come into this? Let's go back to that key word, 'global'. The web of debt funding is built on undertakings to pay back what you borrow, and so is the world banking system. The fear is this latest debt crisis would set off a GFC Mk 2, with credit markets frozen again, which would affect our banking system and its ability to offer credit to businesses and households.

Fortunately, the world has reacted quickly this time but not always well enough to calm the markets. For example, the US Federal Reserve Bank announced it will keep interest rates near zero in order to prevent a credit freeze, and the G7 countries and the key European players are planning rescue packages for the eurozone.

Share market reactions have been swift, with steep falls followed by rises, then more falls. It may take many years for the US and Europe to get their debt under control and pay it off so neither the world — nor Australia — is out of the woods yet.

In Australia's case, our close economic alliance with China will continue to shelter us from many of these woes, but in the twenty-first century we are part of a global market place so cannot escape them completely.

What does 'sovereign debt' mean?

In simple terms it refers to borrowings by a national government against securities issued by the Treasury of the same government. Unlike personal or mortgage loans, there is no security or collateral involved, just the creditworthiness of a country, expressed as a credit rating.

PROTECT YOUR

INCOME

For most people the biggest financial asset is not the family home, a car or money in superannuation, but the ability to earn an income.

However, for many people it seems this penny hasn't dropped. While 83 per cent of Australians have car insurance, only 31 per cent of Australians have income protection insurance.[1]

The average wage earner can expect to earn more than $2.6 million during their working life,[2] but if something goes wrong and you have a prolonged illness or disability, who will pay the mortgage and support your family? Even if you have some cover via your super plan, will it be sufficient?

Taking cover

Income protection insurance provides monthly income if you are unable to work due to sickness or injury. It can provide continuing payments, indexed with inflation, of 75 to 80 per cent of pre-disability income, all the way to age 65. Luckily, there has never been a better time to buy cover, with new choices available and improved flexibility.

Even better, the cost of cover has fallen significantly with average monthly premiums dropping by about 15 per cent.[3]

Tax advantages

Income protection benefits are taxable, but one advantage of having income protection outside super is that premium payments are tax deductible at the insured's marginal tax rate, which is often higher than the 15 per cent tax on super contributions. You can also pre-pay 12 months' premiums in advance and bring forward the full tax deduction to the current financial year.

The cost of cover depends on your level of benefits, the maximum benefit period, your age, gender, occupation and smoking status, the waiting period before benefits are paid, and optional extras. Waiting periods can be anything from 14 days to two years.

Premiums will vary according to the options you choose. Premiums increase as you reduce the waiting period, for example, or if you are a smoker or have poor health at the time you take out the policy. However, once you are insured, the insurer cannot cancel the policy, even if there are adverse changes in your health. It is always advisable to take out insurance when you are healthy, to ensure the lowest premiums both now and into the future.

Choosing your options

Income protection is sold on either an agreed-value basis, where you set the benefit level when you take out the policy, or an indemnity basis, where the benefit is determined by your gross income in either the 12 months or two years prior to disability.

If available, agreed value is generally preferable where income can vary significantly from year to year. Indemnity cover may be more attractive where income is stable, or increases each year.

There are now many options available in this vital area of insurance, and if you want to discuss them with us, please give us a call and we will be happy to talk with you.

1. Lifewise (lifewise.org.au)
2. ABS (abs.gov.au) adult average weekly earnings Feb 2011 times 40 years
3. Rice Warner Actuaries
4. This policy information was provided by OnePath. Policies provide a range of options such as partial disability benefits. Specific financial advice should always be sought when taking out personal insurance such as income protection insurance.

Caroline's story

Caroline was an experienced skier. But when a beginner crossed her path, sending her careering into a tree, she damaged a disc in her spine and spent six months off work. Because she was not able to perform her usual duties as a nurse, Caroline's income protection policy paid 80 per cent of her income while she was off work.

With no annual leave after the holiday and only a few sick leave days available, this money helped Caroline pay her rent and household bills for six months. It also allowed her to ease back into work part-time, as her policy continued to pay her benefits after she returned to work. Once she started back, the insurer paid the difference between her reduced part-time pay and her total insured benefit. This gave her the financial breathing space she needed to get back on her feet … and her skis.[4]

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SAVING THE NEW 'black'

Not so long ago, being frugal implied you were stingy or mean. To go without something could be seen as an embarrassing admission that you were too tight to buy it.

The good news for anyone starting to feel the pinch of rising living costs and a slowing economy is that being frugal is rapidly emerging as the new 'black', just the right tone for the current emphasis on saving.

A new look?

Thanks to today's economic uncertainty, being resourceful and careful with one's money now, not only looks smart, it's also trendy.

Cooking at home with fresh, local produce is fast becoming a preferred option to eating out or paying for excessive packaging and processed foods.

Whether it is shopping at farmers' markets, discount stores, or finding bargains online, it all makes good financial sense.

Other tried and proven methods of living within your means or saving for a more comfortable retirement are very much back in vogue; ideas like paying yourself first, thinking before you use the credit card, and using what you already have.

While older Australians are familiar with what it means to stick to a budget and be financially savvy with limited resources, younger generations, (who have only ever experienced an economy that expands) may find it hard to imagine what life must be like when things start to slow.

Old meets new

Social researcher Mark McCrindle says nothing beats the experience and wisdom of grandparents when it comes to making your money stretch further.

A recent survey by McCrindle Research revealed the most valuable financial advice includes such pearls as: 'look after the pennies and the pounds will look after themselves'; 'never spend more than you earn'; and 'you don't need a lot of money to be rich'. They may sound like clichés but they are more like gold nuggets.

"Though each of our grandmothers and grandfathers is unique, our survey results show the character of the builder generation as a whole. … In times of tight household budgets and rising living costs, the advice of our elders who lived through much tougher austerity years is very relevant," says McCrindle.[1]

Employing wisdom's pearls

Most people spend their money in the following order: bills, fun, saving. Given there are always bills to pay and fun to be had it is not surprising saving takes a back seat.

Turning the order around so you pay yourself first is one of the most painless ways to start a good savings habit. Before you pay any bills, buy any groceries, or go to a movie, take something out of your pay and put it in a high interest account.

And if a pay rise or bonus is on the cards, it makes sense to direct it straight to the savings account. You can't miss what you never had, and it accumulates quickly.

Look after the pennies and the pounds will look after themselves is a successful formula. Roughly translated, it means be careful about how you spend your money. Dollars saved or not spent foolishly mean more dollars for the big things when needed, and more dollars to invest, earning income you don't have to work for.

With credit so readily available it can be easy to spend more than you earn. There was a time when debt was something to be avoided and if you wanted something you either had to save up for it, borrow it or make it yourself.

Whether or not we look to our seniors for fashion tips, we have much to learn from the sage financial advice of our elders.

1. 'The Gold in the Grey', McCrindle Research, 2011

General Advice Warning: This advice may not be suitable to you because it contains general advice that has not been tailored to your personal circumstances. Please seek personal financial advice prior to acting on this information. Past performance is not a reliable guide to future returns as future returns may differ from and be more or less volatile than past returns. The material contained in this document is based on information received in good faith from sources within the market, and on our understanding of legislation and Government press releases at the date of publication, which are believed to be reliable and accurate. Opinions constitute our judgement at the time of issue and are subject to change. Neither, the Licensee or any of the National Australia group of companies, nor their employees or directors give any warranty of accuracy, nor accept any responsibility for errors or omissions in this document.

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