FINANCE CONTROL

GOALS - OBJECTIVES - ADVICE - LIFESTYLE

Winter 2010

Welcome

To warm up your winter financial thinking we have prepared our winter newsletter with a look at the recently released Henry Report. This report is likely to set the agenda for tax and superannuation reform in Australia for the next decade in spite of the fact that very few of its 138 recommendations will be implemented immediately. We also examine the implications of Australia's new economic relationship with China - so far it has been a shield against the global financial crisis and the current European debt problem, but is it all good news?

Finally, we show you how children can be given a financial head start that can make a real difference to their future - All you need is time and compound interest! We hope you find this newsletter an interesting read and of course we welcome both your feedback and any issues you care to discuss.

Latest news

Just as we thought there was a break in the clouds, the temperature has suddenly dropped and the economic path looks slippery again. During May we watched fear and uncertainty take hold of share markets around the world.

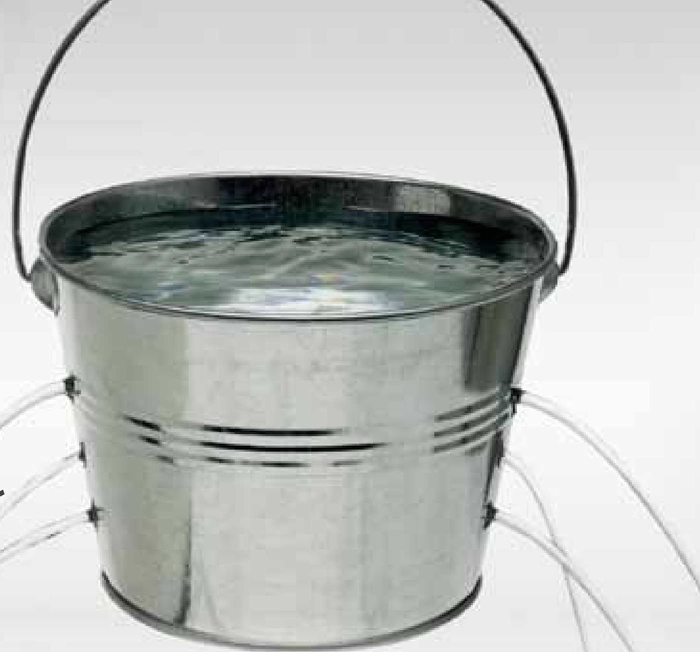
The news from Europe of mega debts and rescue plans has pushed confidence aside. Regional issues added to the uncertainty which unsettles markets: an oil spill off the US coast; arguments in Australia over the Resource Super Profits Tax; conflict in Thailand and Korea. The Aussie dollar dropped sharply, and many major markets suffered significant falls.

While all this was happening, good economic news continued to come through, both locally and overseas. Asia's markets are growing quickly: China, Taiwan, Thailand, Malaysia, and Singapore all grew more than 10% in the year to March 2010. US growth is forecast to be over 3% this year. It is Europe that appears to be in trouble.

Locally, interest rates have reached a neutral setting and may have leveled out for a while, job growth is strong, consumer sentiment has dropped but is still above average and some heat seems to be coming out of the housing sector. The green shoots are there, though Spring will take some time to emerge.

HENRY'S BUCKET

There's a hole in the tax system,
dear Kevin, dear Kevin...
Well fix it dear Henry, dear Henry...



What does the future hold?

Over time the players may change but the sentiment is constant: politicians and Treasury chiefs are always vitally interested in the tax system.

A lot has certainly changed since May 2008 when Treasury Secretary Ken Henry began a 'root-and-branch' overhaul of the federal tax system, with its 5,700 pages of legislation covering 125 taxes[1], plus a look at transfer payments like income support, and state taxes.

The review, which excluded GST and tax-free super for the over 60s, took 18 months to complete and included 1,500 submissions, 4,700 letters, 10 town hall meetings and one policy conference. The Federal Government took another four months to prepare its response.

And as with most major reports, there were a few leaks before Henry's 1,000+ page report, Australia's Future Tax System, was released on May 2 along with the Government's response.

Of 138 recommendations, only a handful have been adopted by the Government so far. Some have been completely ruled out, others put on hold. First cabs off the rank include a resource rent tax, cuts in company tax rates, tax concessions on some savings income, and the introduction of pre-filled income tax returns.

With such a small number of recommendations adopted initially, it is little wonder those expecting major change were disappointed. But major change was never going to happen immediately; it would have been a nightmare both logistically and politically.

Back in 1975, when the Whitlam Government commissioned the Asprey report into the Australian tax system, it was much the same. The report recommended GST, dividend imputation, capital gains tax, and fringe benefits tax but some took the best part of 25 years to be implemented.

Superannuation changes

Henry recommended a number of changes to superannuation: abolishing the contributions tax; taxing super contributions as normal income but with a rebate; cutting the tax on earnings within super from 15 per cent to 7.5 per cent but applying it to both the accumulation phase and the currently exempt pension phase. None of these were adopted.

Instead, a key part of the Government's response is the introduction of a gradual increase in the superannuation guarantee, rising to 9.25 per cent from 2013–14, and moving to 12 per cent by 2019–20.

While this change is designed to increase retirement saving levels, unless there are wage offsets it will add some pressure to small businesses that have to make the higher payments. The impact may also be offset by the lowering of the company tax rate from 30 per cent to 28 per cent from 2012–13, though this does not assist small businesses which are not incorporated. Henry recommended a cut in the company tax rate to 25 per cent over the short to medium term.

Henry also recommended scrapping contributions tax altogether and applying the marginal tax rate to contributions, with a flat refundable rebate. This was changed to a $500 contribution from the Government for people earning $37,000 or less who receive no tax break as their marginal rate is only 15 per cent. The $500 will be paid into super accounts in the financial year after the contribution is made.

Another element of the Government's response you won't find in Henry is retention of the $50,000 concessional contributions cap for those aged over 50 but only if there is less than $500,000 held in super. This kicks in on 1 July 2012. It may encourage more couples to split contributions, to keep one or both superannuation accounts below $500,000 and maximise their contributions. Either way if you can contribute $50,000 a year to your existing account, it won't take long to tip it over $500,000.

The Government also raised the cut-off age for superannuation guarantee contributions from age 70 to age 75 and estimates this will affect 33,000 employees when introduced on 1 July 2013.

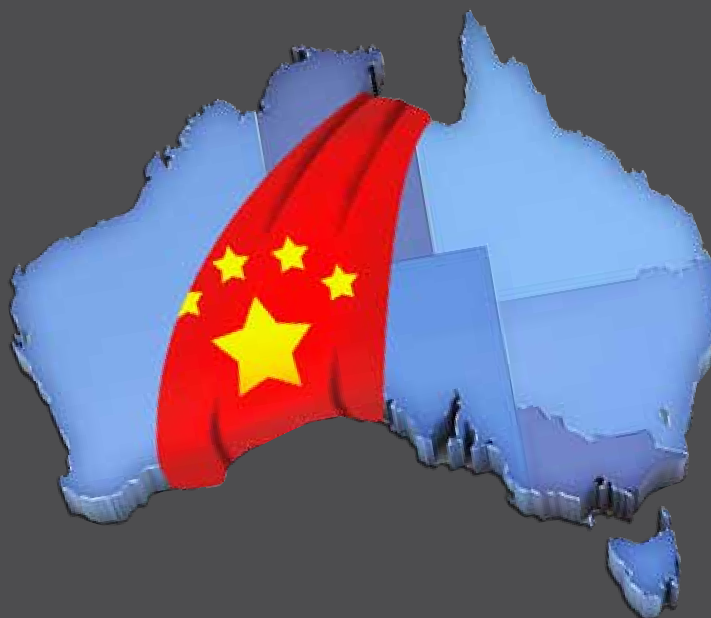
Savings boost

Henry recommended a 40 per cent tax discount on savings income. From 1 July 2011 the Government will introduce a 50 per cent discount on up to $1,000 of interest income. This is designed to encourage lower income earners to save, without diverting large sums away from super.

The Henry report gives us a taxation 'shopping list' to take us into the future. If Asprey is anything to go by, more holes in Henry's bucket may well be filled down the track.

1. Institute of Chartered Accountants; Charter magazine April 2010

AUSTRALIA'S FORTUNES *tied* TO **China**



There has been a fundamental change in Australia's fortunes. Ten years ago, the US was the superpower that most affected Australia's foreign policies and fortunes, because our terms of trade and the value of our currency were strongly linked to the fortunes of the US dollar.

In those days, Japan was our biggest trading partner and China was an underdeveloped country that offered a huge pool of cheap labour to produce US, Japanese and European designed goods.

In 2009, a fundamental change took place when China became Australia's biggest and most important trading partner. China's share of Australia's total exports rose to 25 per cent in the year to December 2009, up from 14.5 per cent in the year to December 2008.[1]

Growing with China

China is the world's economic miracle. Once based largely on cheap exports to the rest of the world, China's economy is now being driven by strong domestic consumption and rapid urbanisation.

As a result, the International Monetary Fund is predicting China will continue to grow strongly, by up to 10 per cent in 2010. In contrast, world growth is expected to be just 4.25 per cent, and US growth only 3.1 per cent.

This growth spurt needs raw materials, and China is now the world's biggest consumer of Australian coal, iron ore and other minerals. Of course, this suggests a better than average outlook for the Australian economy, but economists are now questioning the implications of this long-term trading relationship for the stability of the Australian economy.

Risks and issues

With our future now firmly tied to the prosperity of China and a strong price for coal and iron ore, any major drop in Chinese demand for Australia's minerals has serious ramifications for our economy. So today's multi-million dollar question is: if China sneezes, is Australia likely to catch the flu?

Many economists agree with Glenn Stevens, the Reserve Bank governor, that there is a risk of volatility ahead and, as recent turmoil surrounding the Greek economy has underlined, global economic recovery is still fragile.

On the other hand, many analysts also believe that the Chinese economy is protected from the world's woes because it has been able to 'decouple' itself from the developed economies.

The speed of China's recovery and the underlying strength of its economy post the GFC underpin this positive outlook. Recently, we have seen how the strength of the Chinese economy has not only enabled it to shrug off the recent Greek crisis, but also cushioned Australia from any serious fallout from Europe.

One of the biggest problems facing China today is the threat of runaway inflation caused by its own success. Driven by stimulus measures to protect itself from the worst of the global crisis, China's economic growth surged to 11.9 per cent in the first quarter of 2010 - the fastest growth recorded for almost three years.

This growth spurt raises concerns that the Chinese government will be forced to lift interest rates or cut back on government expenditure, putting the brakes on the consumption of Australian imports.

There are also concerns about a bubble developing in real estate prices as the property sector was a major beneficiary of the Chinese government's stimulus measures. But the government has already taken steps to control this situation.

What lies ahead?

By the middle of 2010, Australia's exports to China and India, the other emerging superpower, are forecast to exceed our total exports to the 'Group of Seven' nations – Canada, France, Germany, Italy, Japan, United Kingdom and United States – and this would have been almost unthinkable a decade ago.

So far, our close trade relationship with China has done Australia's economy nothing but good. The growth in Chinese imports, boosting our own internal stimulus measures, has helped Australia to be one of the first and fastest countries to recover from the global financial crisis. Now, strong exports from China have sheltered us from the economic problems of Europe, and it is largely due to these positive trade projections, that the Australian economy is predicted to be in the black by 2013.

To protect ourselves in the future, Australia will have to balance the weight of the Chinese relationship as the world slowly emerges from recession. By continuing to maintain and build trading relationships with the US, Japan, Europe, South East Asia and fast emerging India, Australia may have more opportunities to balance the risk, just as an investor diversifies an investment portfolio to reduce risk.

1 JBWere China and Australia – Intertwined Fortunes, 4/2/10

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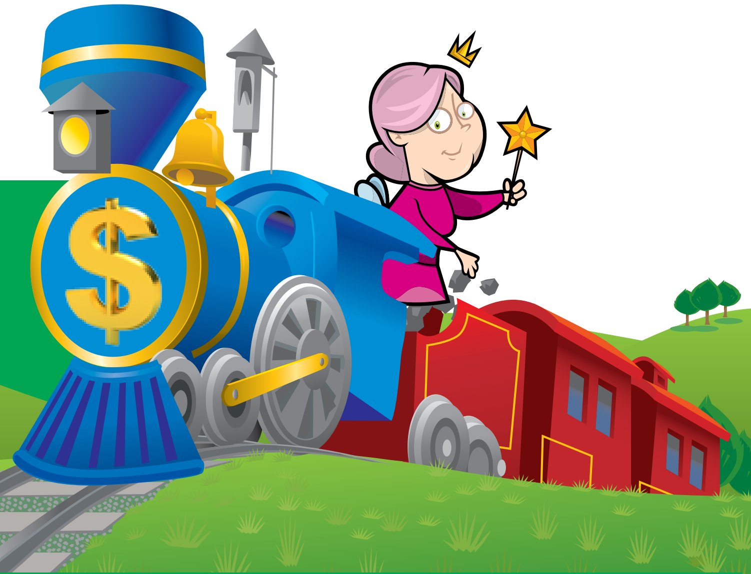
the Magic of COMPOUNDING



A million dollar investment that costs only $50,000. And it's child's play.

A regular savings plan has the power to turn pocket change into hundreds of thousands of dollars. This makes the beginning of a new Financial Year a very good time to take stock of your savings habits, not just for your own benefit, but for the future prosperity of your children and grandchildren.

In fact, there is such a simple way to set your child or children up for life, it's a wonder more parents don't know about it or follow it.

You can read all about it in the fable of the "Fairy Godmother and the Magic Train", as told by popular Australian finance writer Noel Whittaker.[1] In his story, Noel tells you how you can buy your new born baby a seat on the magic train for free and pay only $2.74 a day to retain the seat – less than the price of a decent cappuccino.

The train, which starts off the size of a tiny toy, keeps on growing year after year as it is loaded with more and more gold, yet you (or perhaps the child when he or she is grown up and earning) never has to put in more than $2.74 a day - $1,000 a year.

The end result is amazing. Assuming a long term annual interest rate of 9.2% p.a. (High Growth Investor), the child's nest egg train will be worth over $63,000 when he or she turns 21, $257,000 at age 35, a million dollars at age 50 and a staggering $2.6 million at age 60.[2]

The magic, of course, is not in the train but in compound interest. By reinvesting all the earnings, you earn interest on the interest and the capital amount snowballs over the years.

It sounds so easy, there has to be a catch – and the major 'catch' is time. For example, in the last decade your freight train turns into an express train and more than doubles in value from $1 million to $2.6 million. So to maximise the investment, you have to think long term and keep putting away the small sum of $1,000 year after year.

A delay in boarding the train can be expensive. If the child delays boarding the train until they are 10 years old, the initial investment has to be just over $16,300 to buy a seat on the train and get to the same place at the same time with a daily investment of $2.74 ($1,000 a year).

As you would expect, the other major factor affecting the final size of the nest egg train is the interest rate. If the long term annual interest rate was only 8% p.a. (Balanced Investor), a daily investment for a new born baby would have to be $3.22 to achieve the same outcome at age 21.

Converting $50,000 into $1 million takes a long time and a bit of self discipline – even though the annual investment of $1,000 is only coffee money. However, there is one comforting thought. Even though your child may not grow up to be as disciplined as you are, the magic of compound interest is still on his or her side.

Here's why: Let's assume your child takes charge of the investment at age 21, but stops contributing the $1,000 a year. As long as he or she keeps the money invested and the capital is left undisturbed and earning compound interest, it still builds up to a very impressive nest egg. In fact, if interest rates were 9.2% p.a., the investment would be worth a million dollars at age 53 and just under $2 million by age 60![3]

Thanks to the magic of compound interest, a million dollars return on a $50,000 investment is no fairytale!

1. Noel Whittaker, More Money, 1990. The interest rate used in the article was 10% p.a.
2. Assumes interest is calculated monthly. The money train concept is based on the power of compounding and the time value of money. Inflation and other factors will impact the present value of future returns. Interest rates shown in this document are illustrative only and they are not guaranteed rates of return.
3. Work it out for yourself at www.moneychimp.com/calculator/compound_interest_calculator.htm

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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